



**St. Mary's University**  
**School of Graduate Studies**  
**Master of Business Administration**

**CHALLENGES AND OPPORTUNITIES OF IMPORT SUBSTITUTION  
INDUSTIALIZATION IN ETHIOPIA**

**Submitted to School of Graduate Studies in Partial  
fulfillment of the requirement for degree of Master's in Business Administration**

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**June 2022**  
**Addis Ababa, Ethiopia**

## Approval

This is to certify that the thesis paper, entitled “Challenges and Opportunities of Import Substitution Industries in Ethiopia” Submitted to St. Mary’s University, School of Graduate Studies in Partial fulfillment of the requirement for degree of Master’s in Business Administration complies with the regulations and meets the standards of the institution.

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## Declaration

This is to certify that I, Bisrat Ermias, carried out this research on the topic entitled **Challenges and opportunities of import substitution Industrialization in Ethiopia**. This work is original in nature and the outcome of my own effort and study. All sources of materials used for the study have been fully acknowledged. I have produced it independently except for the guidance and suggestion of the research advisor. This study has not been submitted for any degree in this University or any other University. It is prepared in partial fulfillment of the requirement for degree of Master's in Business Administration.

**Signature:** \_\_\_\_\_

**Date:** \_\_\_\_\_

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## List of Abbreviations and Acronyms

ADLI	Agricultural Development Led Industrialization
EIC	Ethiopian Investment Commission
EOI	Export-Oriented Industrialization
EPRDF	Ethiopian People Revolutionary Democratic Front
FDI	Foreign Direct Investment
FFYP	First Five-year Plan
GoE	Government of Ethiopia
GTP	Growth and Transformation Plan
IAIP	Agro-Industrial Parks
ICT	Information and Communication Technology Development
IDS	Industrial Development Strategy
IPDC	Industrial Parks Development Corporation of Ethiopia
IP's	Industrial Parks
IS	Import Substitution
ISI	Import substitution Industry
MLSM	Medium and Large-Scale Manufacturing
NBE	National Bank of Ethiopia
PASDEP	Plan of Action for Sustainable Development and Eradication of Poverty
PLC	Private Limited Companies
S.C	Share Co
SAP	structural adjustment program
SOEs	state-owned enterprises
VAT	Value Added Tax
WB	World Bank
ADLI	Agricultural Development Led Industrialization
EIC	Ethiopian Investment Commission
EOI	Export-Oriented Industrialization
EPRDF	Ethiopian People Revolutionary Democratic Front
FDI	Foreign Direct Investment
FFYP	First Five-year Plan
GoE	Government of Ethiopia
GTP	Growth and Transformation Plan
IAIP	Agro-Industrial Parks
ICT	Information and Communication Technology Development
IDS	Industrial Development Strategy
IPDC	Industrial Parks Development Corporation of Ethiopia
IP's	Industrial Parks
IS	Import Substitution
ISI	Import substitution Industry
MLSM	Medium and Large-Scale Manufacturing
NBE	National Bank of Ethiopia
PASDEP	Plan of Action for Sustainable Development and Eradication of Poverty
PLC	Private Limited Companies
SAP	structural adjustment program
SOEs	state-owned enterprises
VAT	Value Added Tax
WB	World Bank

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## Abstract

*Import substitution industrialization (ISI) is a theory of economics typically adhered to by developing countries or emerging-market nations that seek to decrease their dependence on developed countries. The overall goal of this research is to evaluate the challenges and opportunities of import substitution in Ethiopia. To conduct this study, the researcher used descriptive study believing that descriptive research describes phenomena as they exist, and it is used to identify and obtain information on the characteristics of a particular problem or issue. To acquire the intended study outcomes, the researcher used both qualitative and quantitative research methods. The study's target population were manufacturing industries engaged in IS. in and around Addis Ababa. List of potential respondents were acquired from Ethiopian Chamber of commerce and Sectoral association. Accordingly, the researcher identified respondents by using non-probability sampling approach, specifically convenient sampling technique by targeting those available in a certain time and place. The study discovered that bureaucratic inefficiency, unstable or insecure political or social conditions, heavy dependency on imported raw material, High customs duties on imported capital goods and intermediary goods, undeveloped economic and legal systems, and arbitrary application of the legal system, difficulty of obtaining well-trained management and engineering personnel, shortage of foreign currency as major challenges of ISI in Ethiopia. On the other hand, Ethiopia being one of the most populous nations, there is a huge unsatisfied domestic demand, clear industrial policy and existence of attractive fiscal and non-fiscal incentives, construction of industrial parks, and availability of electricity and telecommunications network are found to be the major opportunities of import substitution industrialization in Ethiopia. The study recommends that GoE should put in place systematic accountability measures and service level agreements to improve the country's ease of doing business practice especially the bureaucratic procedures to get license, construction permits, land, customs clearance, paying tax and getting basic infrastructures such as electricity. Put in place mechanism to evaluate competitiveness and cost benefit of each sector before providing huge incentives to investors. Encourage private companies and other stakeholders to invest in local raw materials supply chain to produce more such as agricultural products or improving efficiency of sourcing and by modernizing supply chain for the manufacturing sector. Allow foreign banks to operate in Ethiopia or by encouraging private financial institutions to operate in the desired level of competitiveness. Government and private learning institutions should consult with industries to identify key skilled manpower gaps for subsector and design strategy accordingly.*

**Keywords:** *Import Substitution, import Substitution Industrialization, Manufacturing*

# CHAPTER ONE

## INTRODUCTION

### 1.1. Background of the study

Before we look at the challenges and opportunities of import substitution, let's review some fundamental background information on the subject. Import Substitution (IS) is a theory of economics typically adhered to by developing countries or emerging market nations that seek to decrease their dependence on developed countries. The primary goal of the import substitution industrialization theory is to protect, strengthen, and grow local industries using a variety of tactics, including tariffs, import quotas, and subsidized government loans. Countries implementing this theory attempt to shore up production channels for each stage of a product's development (Segal,2021).

Import Substitution (IS) is generally referring to a policy that eliminates the importation of the commodity and allows for the production in the domestic market. The objective of this policy is to bring about structural changes in the economy. The structural change is brought about by creating gaps in the process of eliminating imports and thus making investment possible in the nontraditional sectors (Clark, 1990).

From a war-torn and famine-plagued country at the beginning of the 1990s, Ethiopia is today emerging as one of the fastest-growing economies in Africa. Growth in Ethiopia has surpassed that of every other sub-Saharan country over the past decade and is forecasted by the International Monetary Fund to exceed 6 percent over the next two years. The government has set its eyes on transforming the country into a middle-income country by 2025, and into a leading manufacturing hub in Africa (Gebreyesus,2008). Despite its recent impressive growth performance, Ethiopia remains among the world's poorest countries. Agriculture continues to be the main source of livelihood employing 85 per cent of the country's labor force. The industry contribution to the economy remains at about 14 per cent, far below the average for SSA countries (Gebreyesus,2008).

According to Mulu, a conscious move to stimulate industrial growth in Ethiopia began in the mid-1950s with the formulation of the First Five-year Plan (FFYP). Ethiopia has seen three different governments over the last eight decades. In keeping with the political ideologies governing the economic principles of the time, these successive governments adopted different policies for the development of industry in Ethiopia. The current Government plans to privatize leading state-owned enterprises signal a significant shift toward market-based reforms and a new flexibility

with respect to economic policymaking. At the moment, implementation of import substitution is not as effective as it should be compared to the great emphasis given by the government, such as, giving out several incentives to attract ISI and the potential that the country has in terms of resources and market, Ethiopia's ISI has a longways to go to achieve the desired outcomes.

According to the newly endorsed home growing reform agenda, the government clearly states that efforts will be made to achieve a varying degree of import substitution of wheat, cotton, rice, and oilseeds (i.e., for agro-industries), and sufficient and high-quality production of lowland pulse commodities as well as sesame for the export market. Irrigation based small-scale commercial production of select commodities. By doing so, the government aims to reduce mounting debt, a shortage of foreign exchange, a swelling unemployment rate, inflation, low productivity, and workforce skills mismatched to the economy's needs.

Development planners, until the late sixties used the import substitution strategy as a pillar of all their efforts. This strategy is based on industrialization through establishment or boosting of existing enterprises producing goods which were formerly imported. There are two prerequisites to this strategy of development. First, a country must have a substantial amount of imports and secondly new manufacturing industries, which are to produce the goods that take the place of commodities formerly brought in from abroad. (Hope, K. R., & Misir, D., 1981).

As such, this research reviewed theories of IS both those favoring it and who oppose it, historical background of IS practice in Ethiopia and lessons from other countries. The research also investigated challenges and opportunities of import substitution practice in Ethiopia by examining import substitution policy, incentives provided to ISI, existing market potential, local resource availability, human resource issues and infrastructure availability. Furthermore, results of import substitution policies such as changes in the volume and share of goods produced on the territory of the country, its contribution in alleviating foreign currency crisis, job creation and its contribution towards technology and knowledge transfer were explored.

## **1.2. Statement of the Problem**

Ethiopia's reliance on relatively few agricultural exports, coupled with dependence on imported intermediate inputs, such as capital goods and fuel as well as food has led to a widening structural trade deficit(USDA, 2020). In many developing countries, import substitution and export promotion are often encouraged through protective measures such as tariffs, quotas, and export subsidies. The protection is even more complete when the immediate product and the intermediate input used in producing the product are protected from foreign competition, and, if the domestic markets are competitive, the domestic resource costs (and prices) of the protected

products may remain substantially below the price of imports (in domestic currency) (Prescott, 1983).

Ethiopia faces a growing trade deficit and micro economy imbalance with total imports increasing on average by 12.5% per year during the previous 10 years. The rise in the trade deficit has been driven by rising imports, which ballooned from \$3.6 billion in 2010 to \$12.5 billion in 2017, the peak of Ethiopia's trade deficit. Concerned by the widening trade balance, the Government of Ethiopia (GOE) works to suppress imports and has undertaken other macroeconomic measures in recent years, which has resulted in a narrowing of the trade deficit to \$12.3 billion in 2018 and to \$11.6 billion in 2019. (ITA, 2021).

In September 2019, the Government of Ethiopia launched its new economic policy strategy termed the Home-Grown Economic Reform Agenda, designed to eliminate macroeconomic imbalances, and lay the foundation for sustainable and inclusive growth. The reform aims to transition the Ethiopian economy from a public sector led model to one that is driven by the private sector. The inauguration of Integrated Industrial and Agro-Industrial Parks (IAIP) at different corners of the country aiming to show the commitment of the government has attracted so many investors and started to bring positive outcomes such as creation of job opportunities to the growing number of unemployed youths.

According to Segal (2021), several studies have been conducted to examine success of countries initially implemented ISI policies in the global south (Latin America, Africa, and parts of Asia), where the intention was to develop self-sufficiency by creating an internal market within each country by subsidizing prominent industries, such as power generation and agriculture, and encouraging nationalization and protectionist trade policies. Ogujiuba et al, (2011) detailed that, countries that applied such techniques and adopted the scheme experienced some level of growth – evident in, for example, an upswing in income per capita in Japan and other Asian economies like Malaysia, Thailand and Indonesia after 1973.

Contrary to this, other studies reject the idea of ISI by saying that this high wall of protection, grew an inefficient industrial sector, whose products had prices that were much higher than world prices. Williams (2015) cited by Jakson, stated, It was quite noticeable that the level of protectionist status promoted by governments in many of the Latin America, Asia and Africa economies were not sufficiently comparable to that promoted through market-led developed economies. This generated another problem since it lowered the purchasing power of wages. Protection drove a wedge between world and domestic prices and imposed a heavy burden on consumers (R.Adewale, 2017).

Even if questions around critiques of ISI remain a concern, more so about its protectionist status and the slow pace of growth in terms of promoting export-led activities, it is still perceived as a way forward for countries to become self-sufficient in sustaining decent living condition for citizens. The implementation ISI is a potential means for addressing problems relating to high dependence on import-led commodities, with surmounting pressures on under-developed economies' capacity to meet high cost of import bills and currency depreciation.

Again, as far as the researcher knows, only few researches made by different scholars mostly focusing on importance of ISI for Ethiopia and related government policies and incentives. Even if such related studies have been conducted, with the best knowledge of the researcher, no one tried to examine challenges and opportunities of the sector holistically and end to end with conclusive recommendation that may help policy makers in future policy makings.

Therefore, by means of both primary and secondary data, this study tried to investigate major opportunities and challenges of ISI in Ethiopia.

### **1.3. Research Questions**

The research tried to answer the following questions by employing different research methodology and analysis. The questions include:

- 1) What are the different enablers in place to stimulate import substitution in Ethiopia?
- 2) What are the major challenges faced by import substitution industries in Ethiopia?
- 3) What are the major opportunities faced by import substitution industries in Ethiopia?
- 4) What should be done to curb challenges and streamline import substitution efforts of the country?

### **1.4. Objective of the Study**

#### **1.4.1. General Objective**

The general objective of this research is to assess the opportunities and challenges of import substitution industries in Ethiopia.

#### **1.4.2. Specific Objectives**

The Specific objectives of this study are the following:

- To examine the various policies and regulations in place to encourage import substitution in the country.
- To identify major challenges of ISI in Ethiopia.
- To identify major opportunities of ISI in Ethiopia.
- To make crucial recommendations based on the findings of the research that can help the country's import substitution efforts.

### 1.5. Significance of the Study

At macro level, by scrutinizing opportunities and challenges of ISI of Ethiopia, the study will evaluate current initiatives, government policy direction, effectiveness, and challenges in implementing import substitution policies and provide recommendations to policy makers.

At micro level, the research will benefit new enterprises who wishes to enter in one of IS targeted sectors by clearly pointing out the challenges and opportunities that the industry has including socioeconomic factors, policy directions, financial constraints, infrastructure, and raw material availability to sustain the industry and get desired level of returns. Furthermore, this research may serve as a tool for further similar studies as reference for those who interested to do similar undertaking in the future.

### 1.6. Scope of the study

The study has conceptual, time and geographical delimitation as stated below.

**Conceptually**, the study is delimited to studying the challenges and opportunities of import substitution industries in Ethiopia.

**In terms of time frame**, the study major findings are delimited in assessing challenges and opportunities of ISI by analyzing the past five years major happenings, policies formulated and manufacturing sector performance.

**Geographically**, the study is delimited to ISI found in and around Addis Ababa. This is in consideration of time and budget limitation to conduct the research in other regions of Ethiopia. Accordingly, the findings may not reflect realities of the rest of the country.

### 1.7. Organization of the research

The research paper has been organized in five major chapters. An introduction part that gives an overview of regarding the study including background of study, statement of the problem, research objective, significance of the study, scope of the study and limitation of the study. Chapter two deal with the related review of literature. Chapter three will deal with research methodology, research design, research approach, source of data, instrument of data collection, target population, method of sampling size, data collection method and data analysis methods. Chapter four deal with result and discussion, analysis of the sampled respondents. Final chapter will discuss conclusion and recommendation.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1. Definition of import substitution**

Import substitution industrialization (ISI) is an industrial development program based on the protection of local infant industries through protective tariffs, import quotas, exchange rate controls, special preferential licensing for capital goods imports, subsidized loans to local infant industries, etc. (Ogujiuba et al, 2011). Import substitution industrialization (ISI) is a theory of economics typically adhered to by developing countries or emerging-market nations that seek to decrease their dependence on developed countries (Segal, 2019).

The above definitions have provided some basis on which ISI was developed; this is simply to capacitate means for less developed and emerging market economies to channel ways of becoming self-sufficient in their efforts to harness industrial growth and development. It is a form of self-actualization to enhance prospects in reducing high dependence on the importation of essential goods from the rest of world, thereby creating opportunities through which less favorable and emerging economies can create the capacity to commence industrial production.

#### **2.2. Import Substitution as an approach to industrialization**

In many developing countries the policy of import substitution has occurred either as a normal process resulting from economic growth or as a deliberate policy to encourage industrialization with considerable government intervention. Historical studies show that at the early stage of development a country's import requirements will grow faster than its export as a result of economic development. Therefore, due to structural imbalances between import demands and supply of foreign exchange, a natural incentive to avoid balance of payment difficulties encourage substituting domestic for imports. Increased taxation of international trade, especially at the low level of development, and taxing consumer goods conform to a development policy to mobilize resource for investment in an attempt to substitute domestic production for imports.

Chenery (1990) in his research concluded that industrial growth has three causes, substitution of domestic production for imports, growth in the final use of industrial products, growth in intermediate demand stemming from the above. He emphasized the effects of market size which has increased by either a rise in income level or population. When there are economies of scale in production, an increase in market size lowers cost of production and permits substitution of domestic products for imports. An increase in the size also affects output indirectly by increasing intermediate demand for other industries which experience import substitution.

Hirschman (2004) describes four different origins for industrial growth. Besides war which can bring a strong impulse to industrialization, he emphasizes; import substitution in response to growth of domestic market (brought about by rising exports), import substitution as a (forced) result of balance of payment crises brought on by increased spending for development.

Deliberate intervention of the government to import substitution, may be induced by the numerous advantages that appear attractive at the beginning. Import substitution is initially attractive because it meets a demand that is already known and can be measured by existing imports. It offers the possibility of beginning with the easiest, final stage processes until more experience is gained with modern industrial technology. Local production of consumer goods provides visible evidence of self-reliance and can save foreign exchange (if it involves substantial contributions from domestic inputs including labor and capital, as well as raw materials), an additional attraction is that import substitution can be implemented through policies that protect domestic production and can be seen as a move toward economic independency and political stability.

### **2.3. Challenges and opportunities of import substitution industries**

Every year, Ethiopia imports billions of dollars of goods that can theoretically be manufactured locally. Replacing these imported products with locally produced goods presents a significant opportunity for businesspeople and investors. But while the opportunity for increased local manufacturing is clear, achieving success as a factory owner is not so straightforward. One of the biggest challenges is a shortage of foreign currency; ironically, this is largely because Ethiopia imports more than its exports. Many of the raw materials – such as agricultural produce – used by local manufacturers must be brought in from abroad. However, this is not possible if there isn't enough available international currency to pay the foreign supplier. (MARITZ, 2020). Both high demand for imported goods and weak export performance due to unfavorable terms of trade for primary commodities put stress on the country's balance of payment. There is high demand for imported goods for two major reasons. The first is the high demand for imported consumption goods following the rise in income. The second reason is the high demand for capital goods and raw materials including fuel due to the investment expansion in the country (UNDP, 2020)

The transport logistics of importing these raw materials is another obstacle for Ethiopian factories. The country is landlocked and depends on the port of Djibouti for much of its imports. However, the port is often congested, leading to delivery delays of vital factory inputs. To compensate for these delays, Ethiopian-based manufacturers need to import more raw materials than they require, and this negatively impacts their cash flow.



Transporting goods from Djibouti is also expensive. While the situation has improved with the construction of a new rail line between the port and Ethiopia's capital Addis Ababa, it is sometimes difficult to find space on the train(MARITZ, 2020).

The current condition in Ethiopia showed that the power supply is severely below the required amount for medium as well as large scale industries. The result also showed that despite the country's effort in building hydroelectric dams and other renewable power generation stations, the country still suffers from shortage of electric power supply (MARITZ, 2020).

For many Ethiopian manufacturers, sourcing raw materials locally is also not an alternative. The manufacturing sector in Ethiopia has been relying on imported raw materials even in the areas where the country was supposed to have a comparative advantage. There are three aspects of the problem related to the domestic raw materials constraint: shortage, seasonal supply, and poor quality (UNDP,2020). Despite the favorable climate and large swathes of arable land, the quality of the produce grown by local farmers is often not of a high enough quality to be used in food processing. For instance, while Ethiopia exports fresh tomatoes, it imports ketchup this is because of the inadequate quality of tomatoes. The same goes for wheat; the quality of locally produced wheat is not as good as the imported variety to produce pasta (MARITZ, 2020).

Internet connections have been so weak, and interruptions are rife. Not only are firms constrained in making online transactions, but also face transaction costs in making transfers through banks, paying bills, and paying taxes when the internet is down at such service points. Technological gap in the form of tacit knowledge is another major problem reflected in the delay of many of the public enterprise projects that were awarded to the domestic firms such as Metal and Engineering Corporation (METEC). One would ask why projects get done when awarded to foreign firms but are delayed and even fail when operated by homegrown firms. The difference should lie in the skill and technological gaps in addition to capacity gaps such as finance (UNDP,2020)

The gravity of the problem posed by these, and other related constraints is manifested by the low rate of capacity utilization. Data from Central Statistical Agency (CSA) shows that the average rate of capacity utilization among large and medium scale manufacturing industries in 2014 was 67 per cent. The rate of capacity utilization for key manufacturing industries such as chemical, leather and metal industries range from 49 to 55 per cent.

## 2.4. Theoretical arguments against Import Substitution

The chief rationale for import substitution in many developing countries is to stimulate industrial growth. The rate of industrial growth normally exceeds that of the rest of the economy under both import-substitution and export-oriented trade strategies. However, the industrial growth rate appears to be higher, and output of primary commodities seems to grow more rapidly under export promotion than under import substitution.

Import substitution, which is rationalized in many countries as a means of reducing dependence on the international economy, seems to increase it as import-substitution activities are import-intensive and require both intermediate and capital goods from abroad to sustain production and growth. Thus, the economy becomes vulnerable to declines in availability of foreign exchange. By contrast, export promotion seems to reduce dependence, in the sense that foreign exchange earnings grow rapidly, markets become increasingly diverse and the economy increasingly flexible.

It is relatively easy to launch an import-substitution policy; initially simple and administratively straightforward regulations offering protection and prohibiting competitive imports provide adequate incentives for the few new investments. As investments multiply it becomes increasingly difficult and costly to monitor and sustain this strategy.

On the other hand, starting an export-oriented growth strategy is difficult and requires a combination of policies and determination on the part of the government that is politically difficult to achieve. However, once started, an export-oriented growth strategy is more likely to be self-sustaining and gather momentum. The increasing supply of foreign exchange permits additional liberalization of the import regime. This strengthens the bias of the regime toward exports.

Import substitution is often encouraged through protection measures such as tariffs and quotas to encourage industrial expansion, serving to attract local investment and stimulate domestic employment. The protection is even more complete where both the immediate product and the intermediate inputs used in producing the commodity are isolated from foreign competition. If the domestic market is competitive the domestic resource cost (and price) of protected products may remain substantially below the price of import (in domestic currency). But in small countries with limited markets, economies of scale often occur only to a single firm, and this does not encourage a competitive structure. Cost escalation may occur where single firm industries dominate the domestic economy and intermediate goods produced by monopolies are sold to single firms producing final goods. So, the excessive prices of suppliers are reflected in the cost curves of the producers of final goods and services.

Therefore, import substitution may be increasingly difficult to pursue under the conditions of domestic cost escalation (Prescott, 1983). Contrary to expectation import substitution industrialization has often increased the economy's dependence on imported goods. Import substitution depends on at least in the beginning on import of capital goods and inputs in the form of semi-finished materials. This can cause a substantial drain on foreign exchange. On the other hand, failure to secure enough foreign exchange from exports leads to difficulties to import materials and parts for domestic production, and there will be recurring cries of underutilization of capacity and work stoppage. Therefore, many people who leave their land to work in the manufacturing sectors remain unemployed (Hirschman, 2004).

## **2.5. Industrial Development & Import substitution policies in Ethiopia**

Industrial policy is a contested issue, especially for low-income countries. On one hand, it is widely accepted that these countries need proactive policies to master the transition from low-productivity resourced-based societies with large informal sectors to more productive, knowledge-based, and formalized patterns of productive organization. On the other hand, deliberate interventions aimed to channel resources into preferential activities may well end up reducing allocative efficiency and creating perverse incentives for investors and bureaucrats alike. This is especially true for low-income countries, where political checks and balances tend to be weak (Gebreyesus, 2008).

An industrial policy can be a vehicle for catch-up and structural transformation, and increasingly such a policy must focus on how an economy is integrated into global trade and production networks. Industrial policy may be defined as “a strategy that includes a range of implicit or explicit policy instruments selectively focused on specific industrial sectors for the purpose of structural change in line with a broader national vision and strategy” (Oqubay 2018). Structural transformation involves the shift (of an irreversible and permanent nature) of people and economic activities between sectors, and from less to more productive activities. It involves diversification (both vertical and horizontal) into new more dynamic activities, fostering domestic linkages and building technological capabilities, and developing the stock of technical knowledge that constitutes wealth(Oqubay 2018).

There continues to be convincing evidence that manufacturing is the engine of structural change and sustained growth. This is because of the greater scope in manufacturing (broadly defined to include high-productivity agricultural production) for economies of scale, learning by doing, technological development, and productivity gains, together with the strong links between

manufacturing and other sectors. Manufacturing also has powerful direct and perhaps even more important, indirect employment effects (Kaldor 1967; Thirlwall 2013).

Another central—and often neglected—component in structural transformation is the strategic role of exports. First, exports drive international learning, and hence catching up (Pasinetti 1981). Second, exports expand demand and increase productivity gains. Third, exports relax the balance of payments constraint, while enhancing the viability of import substitution (Thirlwall 2013). For a late latecomer such as Ethiopia, the key challenge is to be able to catch up by learning from forerunners, and to mobilize abundant, scattered, and underutilized forces for the purpose of development (Oqubay, 2018).

### **2.5.1. The Imperial Regime, pre-1974**

The first implemented promotion of industrial development was the First Five-year Plan (FFYP) that covered the period 1958–62 (Gebreyesus, 2008). The plan envisaged achieving industrial progress through substituting imports with the development of light industry producing consumer goods for the domestic market. In accordance with this strategy, the textile, cement, and food industries were given emphasis in the plan as they were believed to produce products in high demand in the local market which could be produced using the local resources abundantly available in the country. Two more five-year plans, the Second Five-year Plan and Third Five-year Plan, were launched between 1963 and 1973 (Gebreyesus, 2008). During this period, the government extended the incentives to attract investors and continued to strengthen its presence in economic activities. The implementation of these initiatives envisaged in the three successive five-year plans (1958–73) attracted foreign investors and boosted the manufacturing sector. However, by the end of the plan period, the overall industrial base of the country had remained weak (World Bank, 1985).

At that time, manufacturing accounted for 2.6 percent and 4.4 percent of GDP in 1964–1965 and 1973–1974 respectively. In the textile sector, ISI brought benefits in employment creation and foreign exchange savings. Between 1962 and 1969, cotton's share in employment and output reached 40 percent and 33 percent respectively, with numbers employed doubling from 10,100 to 21,610.14. Textile production stimulated backward linkages to cotton production, but its effects on forward linkages (such as stimulating the apparel industry) were weak. In the Awash valley, about 27,000 permanent workers and 60,000 seasonal workers were deployed in cotton plantations (Oqubay, 2018).

### **2.5.2. The Dergue Regime, 1974-91**

In 1974 the Ethiopian Revolution erupted while the country was preparing the fourth five-year development plan. The military government nationalized most of the medium and large manufacturing enterprises and declared 'a socialist economic policy. Industrial activities were reserved exclusively for the state. As a result, the manufacturing sector exhibited a sharp decline, particularly in the first few years following the revolution. A Ten-year Perspective Plan comprising a macroeconomic framework—a Public Investment Program containing an indicative portfolio of projects and production targets for the period 1984/85–1993/94—was formulated (Gebreyesus, 2008). This was modified in 1986 in the Ten-year Development Plan. The nationalization and continued systematic restriction of the private sector from engaging in major economic activities had reduced the emerging vibrant sector into micro- and small-scale manufacturing activities. In contrast the state became the sole responsible organ owning and operating medium- and largescale manufacturing activities. In 1985/86, one decade after the revolution, state-owned enterprises (SOEs) generated 95 per cent of the value added and 93 per cent of the employment of all MLSM (Medium and Large-Scale Manufacturing) enterprises. During the last years of the Dergue regime there was a sharp decline in the Ethiopian economy, particularly in the manufacturing sector. The industry value added at large had also exhibited a similar trend over this period. Policies hostile to the private sector coupled with substantial inefficiency in the public sector were the main causes of this decline.

According to (Cheru,1992) The Ethiopian economy has been constrained by several factors since the 1974 revolution. While the civil war and successive droughts are partly to blame, the institution of centralized planning, the nationalization of land, the over emphasis on state farms to the neglect of small farmers, forced villagization and resettlement programmes, and excessive taxation of peasants contributed to a decade of economic stagnation. Under this policy regime, agriculture could neither underpin economic take-off nor support industrialization. This was a major disaster both for the general economy and for the development of the industrial sector—and it also had profound political consequences (Oqubay, 2018).

### **2.5.3. The EPRDF Regime, 1991-2019**

Soon after the EPRDF-led transitional government seized power it announced that the country would follow a market-led economic policy. The first decade of the EPRDF regime (1991–9) was marked by a series of reforms under the structural adjustment program (SAP) with the aim of reversing the command economic system by way of fostering competition, opening the economy, and promoting the private sector. In this period the government implemented three

phases of IMF/WB sponsored reform programs. The first phase of the structural and economic reform programs took place during 1992/93– 1994/95. A key measure undertaken during this period was liberalization in various markets. The second phase of the economic reform program (1994/95–1996/97) was aimed at limiting the role of the state in economic activity and the promotion of greater private capital participation.

In 2002/03 the EPRDF-led government formulated a comprehensive Industrial Development Strategy (IDS). IDS is based on the government's broader development vision—Agricultural Development Led Industrialization (ADLI)—which was developed in the mid-1990s and subsequently elaborated. The IDS maintains that sustainable and fast industrial development can only be ensured if the sector is competitive in international markets. Hence, the export-oriented sectors should lead industrial development and be given preferential treatment. The plan of Action for Sustainable Development and Eradication of Poverty (PASDEP) 2005/06-2009/10, and the first Growth and Transformation Plan (GTP I) 2010/11-2014/15 and the second Growth and Transformation Plan (GTP II) 2015/16 – 2019/20 gave great emphasis to smallholder agriculture, while in the second and third ones the policy scope was broadened to encompass urban and the industrial sector development. The main emphasis of the IDS is to actively support the export-oriented and labor-intensive sectors. Various policy instruments were introduced to support and guide industrial development.

#### **2.5.4. A Homegrown Economic Reform Agenda**

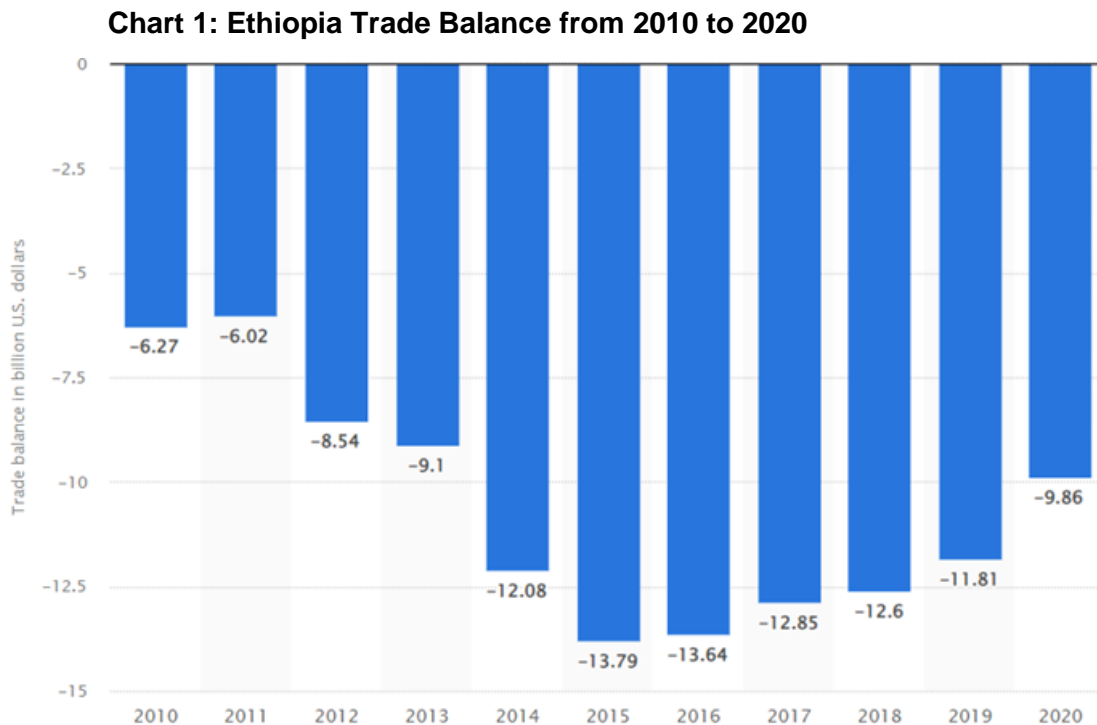
While significant strides have been made, both GTP I and GTP II have not entirely been successful in achieving structural transformation and stimulating exports. The growth has also failed to stimulate private sector development to create decent jobs; gaps remain in ensuring quality universal access to basic services to all Ethiopians. On this backdrop, the GOE is launching a comprehensive and well-coordinated homegrown economic reform agenda with the goal to safeguard macro-financial stability and rebalance and sustain economic growth. The reform agenda builds on the achievements of the past decade in infrastructure and human capital developments. The document further states that, efforts will be made to achieve a varying degree of import substitution of wheat, cotton, rice, and oilseeds (i.e., for agro-industries), and sufficient and high-quality production of lowland pulse commodities as well as sesame for the export market (GoE,2020).

## 2.6. Ethiopia's balance of trade

The agriculture sector has historically been the engine of the Ethiopian economy, but it has recently given way to the expansion of the service sector. According to the National Bank of Ethiopia (NBE), agriculture, industry and services have contributed 32.7%, 29% and 39.5% to GDP respectively during the 2019/20 Ethiopian fiscal year. The agriculture sector's share of GDP shrank by more than 25% between 2005 and 2020, while the service sector's share grew by 28% during the same period. Industry and the manufacturing sectors' share gradually rose, expanding their share of GDP over the past ten years.

The construction industry, particularly roads, railways, dams, industrial parks, and housing development, is the main driver of growth in the industrial sector, contributing more than half of the sector's growth. Large-scale public investment projects have absorbed a significant share of scarce forex, while the forex revenue anticipated from the projects didn't materialize in time. High demand for imports in the context of limited export growth resulted in large current account deficits and severe forex shortages (HERA, 2020).

Ethiopia faces a growing trade deficit with total imports increasing on average by 12.5% per year during the previous 10 years. The rise in the trade deficit has been driven by rising imports, which ballooned from \$3.6 billion in 2010 to \$12.8 billion in 2017, the peak of Ethiopia's trade deficit.



Source: Statista

Concerned by the widening trade balance, GOE works to suppress imports and has undertaken other macroeconomic measures in recent years, which has resulted in a narrowing of the trade deficit to \$11.8 billion in 2019 and to \$9.8 billion in 2020 (Statista, 2020).

According to the NBE, annual report, 33.3% of total import spending (\$5.0 billion) was on capital goods and 28.3% (\$4.3 billion) on consumer goods. The top five destinations for Ethiopia's exports in 2019 were China (13%), the United States (9.6%), Saudi Arabia (8%), Germany (5.9%) and United Arab Emirates (5.5%). By region, Ethiopia's exports comprised of Asia (52%, Europe (24%), Africa (13%), and Americas (11%). The vast majority of Ethiopia's imports come from Asia (67%) followed by Europe (17%), the Americas (9.8) of which the United States accounts for a large share (9.3%), and other countries in Africa (8.1%). Imports from China accounted for 26% of Ethiopia's total foreign supplies (ITA,2021).

## **2.7. Doing Business investment climate of Ethiopia**

Doing Business is a valuable tool that governments can use to design sound regulatory policies. By giving policymakers a way to benchmark progress, it stimulates policy debate, both by exposing potential challenges and by identifying good practices and lessons learned. It's important to note that Doing Business isn't meant to be an investment guide, but rather a measurement of ease of doing business( World Bank,2020) Potential investors consider many other factors, such as the overall quality of an economy's business environment and its national competitiveness, macroeconomic stability, development of the financial system, market size, rule of law, and the quality of the labor force.

By documenting changes in regulation in 12 areas of business activity in 190 economies, Doing Business analyzes regulation that encourages efficiency and supports freedom to do business. The data collected by Doing Business address three questions about government. First, when do governments change regulation with a view to develop their private sector? Second, what are the characteristics of reformist governments? Third, what are the effects of regulatory change on different aspects of economic or investment activity? Answering these questions adds to our knowledge of development.

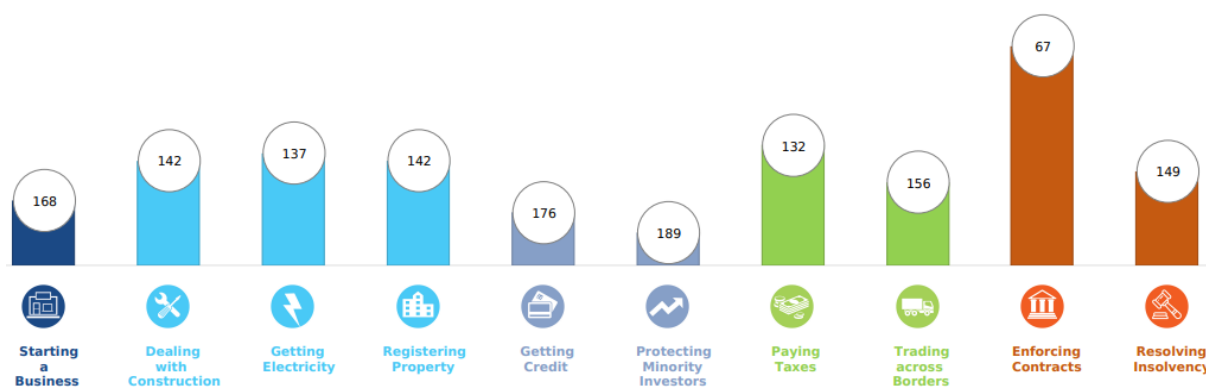
With these objectives at hand, Doing Business measures the processes for business incorporation, getting a building permit, obtaining an electricity connection, transferring property, getting access to credit, protecting minority investors, paying taxes, engaging in international trade, enforcing contracts, and resolving insolvency. Doing Business also collects and publishes data on regulation of employment as well as contracting with the government. The employing workers indicator set measures regulation in the areas of hiring, working hours, and



redundancy. The contracting with the government indicators captures the time and procedures involved in a standardized public procurement for road resurfacing.

Ethiopia is ranked 159 among 190 economies in the ease of doing business, according to the latest World Bank 2020 ratings. As shown in the figure below, Ethiopia is performing weak on most of the criteria's that investors and entrepreneurs consider investing their resources especially in setting up ISI. Ethiopia is ranked 168<sup>th</sup> out of 190 in providing conducive environment to start a business.

**Figure 1: Doing Business evaluation criteria's**



Source: World Bank 2020

## 2.8. Global risk assessment of Ethiopia business climate

The decision to invest in a particular country usually begin with determining the riskiness of the investment climate in the country under consideration. Risk refers to the economic, political, and business risks that are unique to a specific country, and that might result in unexpected investment losses. In general, countries are categorized into three levels of development: frontier, emerging, and developed markets, which are characterized by decreasing levels of country risk accordingly. A country with a higher credit rating is considered a safer investment than a country with a lower credit rating. Examining the credit ratings of a country is an excellent way to begin analyzing a potential investment.

Country risk can be measured using various metrics and studies, including sovereign credit ratings and independent sovereign risk reports. Every investable country in the world receives ratings from such large rating agencies. Fitch is one of the top three credit rating agencies in the world. Fitch Ratings is an international credit rating agency based out of New York City and London. Investors, governments, and lenders use the company's ratings as a guide as to which investments will not default and subsequently yield a solid return.

Fitch offers sovereign credit ratings that describe each nation's ability to meet its debt obligations. Sovereign credit ratings are available to investors to help give them insight into the level of risk associated with investing in a particular country. Countries will invite Fitch and other credit rating agencies to evaluate their economic and political environments and financial situations to determine a representative rating. It's very important to obtain the best sovereign credit rating possible, particularly in the case of developing nations, as it aids in accessing funding in international bond markets. The Fitch rating system is as follows:

- AAA: companies of exceptionally high quality (established, with consistent cash flows)
- AA: still high quality; still has a low default risk.
- A: low default risk; slightly more vulnerable to business or economic factors
- BBB: a low expectation of default; business or economic factors could adversely affect the company
- BB: elevated vulnerability to default risk, more susceptible to adverse shifts in business or economic conditions; still financially flexible
- B: degrading financial situation; highly speculative
- CCC: a real possibility of default
- CC: default is a strong probability
- RD: issuer has defaulted on a payment
- D: defaulted

In 2021, Fitch Ratings has affirmed Ethiopia's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'CCC' (<https://www.fitchsolutions.com/topic/ethiopia>) , reflecting the risk of:

- **A default events**
- **low levels of foreign reserves**
- **Increasing gross external financing needs**
- **The ongoing internal conflict**
- **Declining flow of external financing**

are cited by the agency as challenges for lowering the rating, diminishing the country's standing to service its debt. This result is widely referred by global financing institutions and major investors who would potentially be expected to invest in Ethiopia's ambitious import substitution projects.

## 2.9. Export from manufacturing sector Vs. Import substitution

Development of the manufacturing sector is the path towards the structural transformation of the economy and the creation of jobs for the growing population. Despite efforts to develop the manufacturing sector through various initiatives, such as industrial parks, notable investment promotion, and generous fiscal incentives to investors, in the past decade, the manufacturing sector remains underdeveloped with an output of only 6 percent of GDP. Limited productivity and product diversification, shortage of inputs and forex, high cost of finance, electricity and logistics constraints, and industrial relations have been cited as key constraints for the development of the sector (GoE, 2020). In 2020/21 fiscal year, Industrial sector showed a 7.3 percent annual growth and constituted a 29.3 percent share in total GDP and it contributed 33.6 percent to the overall GDP growth. With 5.1 percent growth, the manufacturing accounted for 23.4 percent of the industrial output (NBE, 2021).

Despite the government ambition of IS, the sector is still challenged by many threats. The figure below reports raw material import dependence and export coverage of imported raw materials. In 2009/10 imported raw materials accounted for about 51 per cent of the total use of raw materials in the MLSM sector. The dependence on imported raw materials is relatively lower in the agro-industries. The chemical, plastic and rubber, basic iron, and engineering industries depend heavily on imported inputs, ranging from 70 per cent to 99 per cent of total cost of raw materials (Ghebreyesus, 2008).

**Figure 2: Export sales and imported raw materials by sector MLSM (2009/10)**

	Exports' share in sales (%)			Imported raw materials share (%)			Exports coverage of imported raw materials (%)		
	2002/03	2007/08	2009/10	2002/03	2007/08	2009/10	2002/03	2007/08	2009/10
Food and beverage	6.00	3.14	1.78	22.03	27.91	24.8	79.88	28.62	16.29
Tobacco	0.00	0.31	0.45	79.84	13.8	5.5	0.00	8.61	12.41
Textile	17.24	14.06	9.19	29.04	29.64	37.0	93.52	80.24	47.60
Apparel	0.10	26.08	12.92	25.66	37.28	50.3	0.79	138.06	55.10
Leather	69.11	61.26	36.27	21.64	23.56	34.4	423.96	382.35	172.86
Wood products	0.00	0	0.05	54.63	23.87	21.1	0.00	0	0.39
Paper and paper products	0.00	0	0.00	75.36	81.54	59.5	0.00	0	0.00
Chemical	0.00	1.58	1.02	72.33	87.06	70.5	0.00	2.92	2.30
Rubber and plastic	0.00	0	0.13	85.00	77.22	92.3	0.00	0	0.27
Other non-metallic mineral products	0.57	0.13	0.07	29.79	19.84	58.1	9.35	4.13	0.26
Basic iron and steel	0.00	0	2.42	99.17	99.8	79.1	0.00	0	4.25
Fabricated metal	0.00	0	1.53	88.97	80.19	84.6	0.00	0	2.92
Machinery and equipment	0.00	0	2.04	92.32	97.68	85.1	0.00	0	4.25
Motor vehicles, etc.	0.00	0	0.00	93.39	97.13	98.5	0.00	0	0.00
Furniture	0.00	0.8	0.00	42.30	52.51	50.1	0.00	3.01	0.01
<b>Total</b>	<b>9.95</b>	<b>6.05</b>	<b>3.03</b>	<b>43.52</b>	<b>53.61</b>	<b>51.0</b>	<b>52.93</b>	<b>24.42</b>	<b>11.65</b>

## 2.10. ISI experience of different countries

### 2.10.1. Brazil

The ISI policy in Brazil dates to the 1930s, especially during the rulership of President Giulio Dornelles Vargas. President Vargas ruled Brazil between 1930 and 1954. During his tenure in office, he institutionalized indigenous technological and industrial development, and initiated policies towards improving agricultural proceeds and ultimately efficient utilization of agricultural surplus (Abreu, Bevilacqua & Pinho 1996). President Vargas was able to create appropriate linkage between the agriculture sector and manufacturing, which translated into effective and efficient utilization of agricultural rents in galvanizing the initial industrialization process of the country. The drive of the President to create indigenous capability eventually resulted in the establishment of the state-owned oil corporation – the Petrobras Brazilian in 1953 (Cason & White, 1998).

President Juscelino Kubitschek took overpower in 1954 and ruled until 1961. During his regime, he built on the state industrialization capacity created through the ISI policy and promoted exportation in targeted industries. The ISI policy remained intact, embedded with various tariffs, duties, and taxes, while the export drive was aided by state incentives – subsidy (Wagner, 1981). The period between 1962 and 1968 was characterized by various uncertainties and economic instability and there was no clear-cut economic achievement until President Emilio Medici came into power in 1969 and ruled until 1974.

During this period, Medici reduced the incentives for import substitution and promoted export of manufactured goods. He redirected the policy focus from light-to-medium industry to heavy industry (machineries and heavy equipment's) (Guimarães, 2004). This economic diversification intervention yielded immediate fruit as the tax to GDP ratio increased tremendously. This increases improved investor confidence in the economy and the country suddenly became juicy to whet the appetite of global financial investors. This development exposed Brazil to unprecedented financial crisis, which almost resulted in economic crisis. However, the ability of Brazil to have whither the storm of challenges posed by the economic openness (liberalism), and still managed to emerge as one of the rapidly developing economies, lies on the institutional capacity that the country establishes during the ISI regimes (Cason & White, 1998).

### 2.10.2. India

The adoption of ISI in India dated back to 1920s, albeit with a great undertone of colonial influence that engendered some degree of liberalization (Schmitz, 2007; Mukherjee, 2012). The period prior to the political independence of India in 1947 was characterized by domestic antipathy towards the colonial (British) business interests in the country. The peak of this

aversion was the orchestration of the doctrine of swadeshi (self-sufficiency) movement, which was meant to promote the nationalist ideology in the country by patronizing only products made in India. It must be pointed out, however, that while the mercantile community, the peasant traders and the shroffs (bankers or moneychangers) canvassed for and endorsed swadeshi's proclamation and its first cousin, the nationalism movement, the larger Indian businessmen were controverting (Chenoy, 1985), which were epitomes of ISI.

An understanding of the Indian economic policy development can best be categorized into four periods, namely the period between 1947–1956, 1957 to 1960, 1961 to 1965 and 1966 until date. The first two periods were characterized by the usual post-independence uncertainties and policy vicissitudes. Although, the pre-independence revulsion of the British business hegemony in the country influenced the policy directions, the lack of support from the domestic moguls as well as the financial/economic crises that the country experienced during this period further constituted a peculiar challenge.

As noted by Kumar (1995:3228–9) “The scope of import substitution extended to almost everything that could be manufactured in the country” and this macroeconomic stance was fortified with high tariffs and quantitative restriction on imports. However, the policy document was rejected by the local mogul, which precipitated the introduction of a refined policy document barely three months later with the Industrial Policy Statement (IPS – Chenoy, 1985). According to Chenoy (1985), in the new policy, although the new industrialization strategy was still underpinned by ISI, there was some degree of flexibility in the practicability of the proposition. For instance, the antagonism against foreign capital was toned down, and the period for the transfer of foreign capital within India to local business interests was elongated.

A year later, the intransigency of the gravamen between the political class and business elites on policy direction led to the replacement of the IPS policy with a more draconic ISI policy, which was surprisingly opposed by some big Indian bourgeoisies that urged the political leadership to revisit the swadeshi orientation. The prevailing recession and deflationary crises of 1952/53 period however, forced a convergence on the relevance and indispensability of foreign capital to the Indian economy, as all parties agreed on inflow of foreign capital that would boost domestic industrialization exercise.

The liberalization efforts that began in the late sixties eventually paid dividend as the domestic consumption expanded and this expansion culminated in further growth and local capacity building in other sectors, especially the heavy industry (Chaudhury, 2009). The ability of India to extend its import substitution from consumables to heavy industry further helped the country to realize its swadeshi targets as local skills capacities were developed and indigenous

technological competence was achieved. It can then be reasonably concluded that the ISI policy was successful in India because the country was able to “haltingly extend import substitution to intermediate and capital goods” (Ahmad, 1978:357). It becomes evident that the ISI policy helped India to develop its automotive, Information and Communication Technology as well as acted as catalyst for the export promotion agenda of the country.

### **2.10.3. China**

Evidence suggests that the current economic prowess of China is premised on the country’s unique macroeconomic policy initiative that was adopted between 1950 and 1995 (Li & Vinten, 1997). These policies were primed on a balanced juxtaposition of two development models - Mao’s closed economy (ISI) and Deng Xiao Ping’s economic liberalization approach (Export-Oriented Industrialization – EOI). According to Zhu (2006), China followed the route of the rest communist states essentially from the beginning of 1950s towards the end of 1970s, but with a unique liberalization flavor that has been dubbed – “market socialism with Chinese characteristics” (Zhu, 2006).

Chinese economic miracle began during the era of Mao Zedong in 1949. Premised on the Karl Marx ideology with the intent to fight/destroy imperialism, the regime of Mao concentrated fully on building Socialism with Chinese Characteristics, in a way that promotes economic, political, cultural, social, and ecological progress of the Republic (Kueh, 2006). To achieve this, Mao primed his policy focus on positioning China as both economic and military superpower.

Mao’s desire to stimulate industrialization in China necessitated focusing attention on developing industrial infrastructure under the auspice of ‘walking on two legs’ slogan that was primed on mechanized farming (Watkins, Undated, Li and Yang, 2005). The macroeconomic policy of the government proved successful, especially by engendering a communal work ethic, coordinated through the pyramidal central control.

Shortly before Mao’s death in 1976, Xiaoping Deng published three documents that focused on his political agenda of Four Modernization. This political focus was directed at agriculture, industry, science technology and national defense. Watkins (undated) summarized these political focus as “electricity in the rural areas, industrial automation, a new economic outlook, and greatly enhanced defense strength” (Tisdell, 2009). The ten-year plan that was released by the ruling party in February 1978 was directed mainly towards developing Chinese heavy industry, as well as its military armament (Schram, 1994, Tokuda, 2007). The regime of Deng was synonymous with astute positive disposition towards economic liberalization, which was a precursor for accessing the much-needed foreign capital to spur the lingering Chinese economy.

This macroeconomic rebalancing was also necessitated by the drive to access world market for the excess domestic production to further the rapid industrialization agenda. The reforms orchestrated during Deng's rulership has been credited with the recent economic achievement of China, premised on the platforms provided by the Confucian cultural orientation, political institution as well as macroeconomic fundamentals, which the regime engendered (Sanders, 1999, Tisdell, 2009).

Although, there were a series of revision and redefinition of the existing macroeconomic policies by the succeeding political leadership after Deng, these leaders continue to build on the CCP's Mao industrialization and economic development ideology (Heilmann & Shih, 2013). To summarize the success of macroeconomic intervention in China, Tisdell (2009: 288) states: "The implication of the above discussion is that the rapid economic growth of the Chinese economy in the last 30 years is due to positive leadership of the CCP, and that continuing improvements in the welfare of the Chinese people depend on the quality of that leadership being sustained".

### **2.11. Empirical review**

Countries that applied ISI and adopted the scheme experienced some level of growth – evident in, for example, an upswing in income per capita in Japan and other Asian economies like Malaysia, Thailand and Indonesia after 1973 (Ogujiuba et al, 2011). With the underlying notion of ISI being part of the need to expand job creation and enhancing welfare opportunities, the outcome as seen from some of the Asian economies is an attestation to their progress in ensuring that the expansion of welfare was made an integral part of governments' objectives in supporting further investment in not only capital intensive industrialization processes, but also accommodating transformational competencies capable of replacing or boosting human efforts in a bid to improve productivity at a much faster rate (Saffa and Jabbie, 2020).

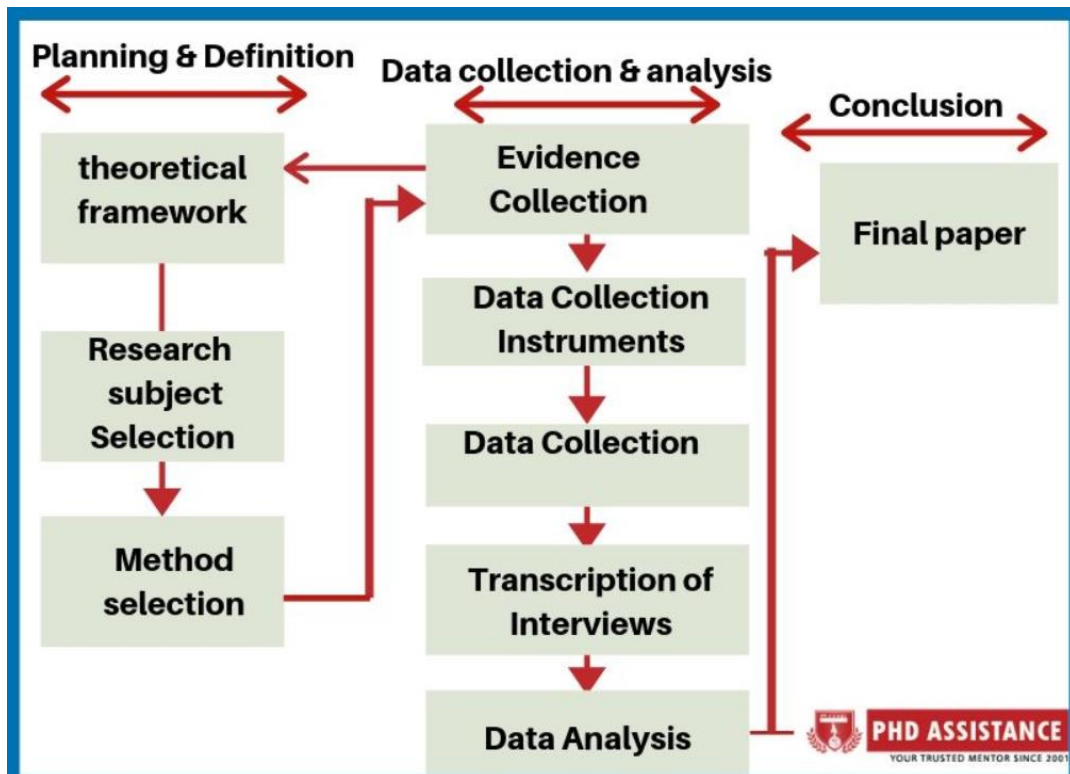
Notwithstanding the rationale for practicalising the economics concept of ISI, critics have levied concerns around its misuse, particularly with entrepreneurs in some industries (notably textiles) using it as a meal-ticket to extract surplus wealth and income from the state for personal benefits (Williams, 2015). In the case of Latin American countries, ISI was perceived to be short-lived, particularly around the 1960s, owing to concerns around uneven trends in production, which was concentrated in consumer goods as opposed to expansion in high intensive industrial production- employment rates were also seen to be declining, with escalation of social strife that resulted into internal migration, and increased inequality (Bussell, n/d). The uneven developments witnessed in smaller economies in the Latin American region meant that critiques were being resounded in institutions all around, notably, the Economic Commission for Latin America and at the University of Chile in Santiago, on account of ISI's

high dependence on Trans-national Corporations (TNC) and lack of stimulation in addressing democratic development (Bussell, n/d). Some promoters of free trade felt that the protectionist status of ISI was a hindrance to capital appropriation, hence preventing economies in the developing world from promoting their comparative advantages in the international trade market. It was quite noticeable that the level of protectionist status promoted by governments in many of the Latin America, Asia and Africa economies were not sufficiently comparable to that promoted through market-led developed economies (Williams, 2015).

### 2.12. Conceptual Framework

The theoretical framework is the structure that can hold or support a theory of a research study. The theoretical framework introduces and describes the theory which explains why the research problem under study exists. Accordingly, based on the overall review of related literatures and the theoretical reviews, the following conceptual model has been adopted to assess Challenges and Opportunities of ISI in Ethiopia.

Figure 3: Conceptual framework of the study



Source: Adopted from PHD Assistance: <https://www.phdassistance.com/blog/why-is-theoretical-framework-important-in-research/>



## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1. Research design and Methodology**

Research design is a master plan specifying the methods and procedures for collecting and analyzing the needed data/information. It is a strategy or blueprint that plans the action for carrying through the research project data (Vaus, 2006). Research design is a strategic framework for action that serves as a bridge between research questions and the execution, or implementation of the research strategy ( Blumberg, Cooper, and Schindler, 2005). Accordingly, the research approach used in this study is mixed or a combination of qualitative and quantitative research approaches as the objective of this study is to identify challenges and opportunities of ISI in Ethiopia.

Descriptive type of research design is used for this research believing that descriptive research describes phenomena as they exist and it is used to identify and obtain information on the characteristics of a particular problem or issue (Geoffrey et al, 2005). The objective of descriptive research is ‘to portray an accurate profile of persons, events or situations’ (Robson 2002).

#### **3.2. Population and Sampling Technique**

The target population of the study are manufacturing industries engaged in IS in and around Addis Ababa. From the catalogue prepared by Ethiopia Chamber of Commerce and sectoral association, 150 ISI were identified operating in Addis Ababa. Pirooska Bisits (2021) suggested that a good maximum sample size is usually around 10% of the population, as long as this does not exceed 1000. Accordingly, the researcher decided to sample 20% or 30 respondents for the study by considering the small population size identified above. Consequently, the researcher identified respondents by using non-probability sampling approach, specifically convenient sampling technique by targeting those available in a certain time and place. Saunders (2012), explained that convenience sampling is a method adopted by researchers where they collect research data from a conveniently available pool of respondents. It is also the most used sampling technique as it's incredibly prompt, uncomplicated, and economical. In many cases, members are readily approachable to be a part of the sample.

### **3.2. Source of Data**

Researcher used both primary and secondary data source to gather adequate and relevant data. Primary data was collected from manufacturing industries engaged in IS found in and around Addis Ababa through questionnaire.

Secondary data was gathered from government publications, international organizations repositories, NBE, EIC and from other books, internet, and previous research made on ISI.

#### **3.2.1. Secondary Data:**

The researcher conducted extensive desk review of literatures and documents (national, regional, international) pertaining to import substitution industrialization (ISI), importance of IS, lessons learned from other countries, GoE policies on ISI- targets and achievements, actor's contribution, sector structure and its effectiveness, raw material supply potential of the country, labor force availability, infrastructure and ease of doing business ranking was gathered from various sources mainly include the following but not limited to:

- GoE Policy and Strategy on ISI (past and Existing)
- Investment proclamation of Ethiopia
- Reports compiled by different national and international institutions
- International organizations publications such as World Bank, AFDB

#### **3.2.2. Primary Data**

Likert scale questionnaire was developed targeting key stakeholders identified above from both the sector associations and private sector. Likert scale provides five possible answers to a statement or question that allows respondents to indicate their positive-to-negative strength of agreement or strength of feeling regarding the question or statement. Likert Scales have the advantage that they do not expect a simple yes / no answer from the respondent, but rather allow for degrees of opinion, and even no opinion at all. Therefore, quantitative data is obtained, which means that the data can be analyzed with relative ease (McLeod, 2008). Considering this, checklist for interview was developed not to miss key representation of sectors and stakeholders.

### **3.3. Instrument of Data Collection**

In this research data was collected both from primary and secondary sources. Structured questionnaire was used to collect primary data from selected respondents. To get the best out of this study, each question in the questionnaire was designed to represent the concepts that are reflected in the background sections outlined above. Anonymity of the questionnaire gave respondents freedom and help the researchers to reach desired level of respondents with

minimum effort. Structured questionnaire includes Likert scale and multiple choice that were addressed the basic research question. The data was collected through non-probability sampling technique specifically through convenience sampling techniques.

### **3.4. Methods of data analysis**

The researcher used both qualitative and quantitative data analysis techniques. The responses that were generated from questionnaire were analyzed by quantitative approach and tabulation of the results shows the number of responses to each question. In addition, frequencies and percentage of respondents who gives each possible response to the questions are narrated qualitatively. Descriptive statistics is used in this study to describe, show and summarize the collected data in the meaningful manner. This is the most appropriate way to assume any patterns emerging from the data for meaningful interpretation. Data analysis was done using advanced statistical spreadsheet including production of graphical analysis reports.

### **3.5. Validity and Reliability**

Validity is the extent to which the scores from a measure represent the variable they are intended to. Hair (2007) defined validity as “the degree to which a measure accurately represents what is supposed to”. Validity is the degree to which all the evidence points to the intended interpretation of test scores for the proposed objective. Accordingly, the researcher did content validity of the data collection instrument by carefully linking the questions with the research main objective and background data collected. The researcher also considered the input of the advisor before distribution of the same.

Reliability refers to the consistency, stability and repeatability of results i.e., the result of a researcher is considered reliable if consistent results have been obtained in identical situations but different circumstances (Twycross and Shields, 2004). It refers to the repeatability of findings. Accordingly, proper explanation and sufficient time was given to respondents to carefully analyze and give their feedback accordingly to get reliable and dependable response.

### **3.6. Ethical Considerations**

All the research participants included in this study were appropriately informed about the purpose of the research and their willingness and accord was secured before the commencement of distributing questionnaire. Concerning the right to privacy of the respondents, the study maintain the confidentiality and identity of each participant.

## CHAPTER FOUR

### RESULTS AND DISCUSSION

In this chapter, primary data gathered from the respondents through structured interview as well as major findings from secondary data are analyzed, interpreted, and discussed in detail.

#### 4.1. Findings from secondary data

##### 4.1.1. Opportunities

###### 4.1.1.1. *Industrial policy and structural transformation*

An industrial policy can be a vehicle for catch-up and structural transformation, and increasingly such a policy must focus on how an economy is integrated into global trade and production networks. Industrial policy may be defined as “a strategy that includes a range of implicit or explicit policy instruments selectively focused on specific industrial sectors for the purpose of structural change in line with a broader national vision and strategy” (Oqubay 2015: 18). Ethiopia is one of the few African countries that has formulated a full-fledged industrial policy and aggressively pursued it over the last decade. Understanding the policy choices and the implementation as well as their efficacy is of paramount importance not only for providing feedback to the policy process in Ethiopia but also for drawing lessons from which other countries can learn.

Ethiopia envisions to become a middle-income country And Leading manufacturing hub in Africa by 2025. The target is broader than a quantitative target; includes aggressive poverty reduction and advances in health, education, and the environment. Massive investment by GoE in building industrial parks(IP's) across the country is one evidence shows the commitment of the government. Industrial Parks Development Corporation of Ethiopia (IPDC) is mandated to develop and operate a wide range of industrial parks. IPDC serves as Industrial Park land bank, develops Industrial Parks and hands over to private Industrial Park developers (leases or sub-leases land, sells or rents shades). IPDC aspires to develop 100,000 ha of land between 2016 and 2025 -i.e., 10,000 Ha annually- for a total factory floor area of 10 million m<sup>2</sup> (1 million m<sup>2</sup> annually). So far, 10 industrial parks in Hawassa, Adama, Dire Dawa, Mekelle, Kombolcha, Bole Lemi I and II, Kilinto, Baher Dar, Jimma and Semera become operational specialized in apparel, textile, Food Processing, Pharmaceuticals, House appliance electronics and electronics.

In addition to IP's, GoE launched Integrated Agro Processing Parks (IAIP) project with the objective of driving structural transformation of the Ethiopian economy, reduce rural poverty,

attract increased investment on agro-processing and related sectors. The government has established four pilot agro-industrial parks (Amhara, Tigray, Oromia and Sidama) by directing seed funds to support infrastructure development and monitoring progress through Ministry of Trade and Regional Integration and the Prime Minister Office (EIC, 2021).

According to Ethiopian Investment Commission (EIC), attractive incentives are provided for investors who wanted to invest in Industrial Parks with the following basic category.

#### **Manufacturers**

- Exempted from income tax up to 8 - 10 years
- Exempted from duties and other taxes on imports of machinery, equipment, construction materials, spare parts, raw materials, and vehicles
- No taxes on exports
- One-stop-shop government services
- Land lease term: 60-80 years at zero charge for factories and residential quarters

#### **Developers**

- Exempted from income tax up to 15 years (outside Addis Ababa)
- Land lease term: 60-80 years at nominal rate with sublease rights
- Provision of necessary infrastructure, including dedicated power substations
- Exempted from duties and other taxes on imports of machinery, equipment, construction materials and vehicles

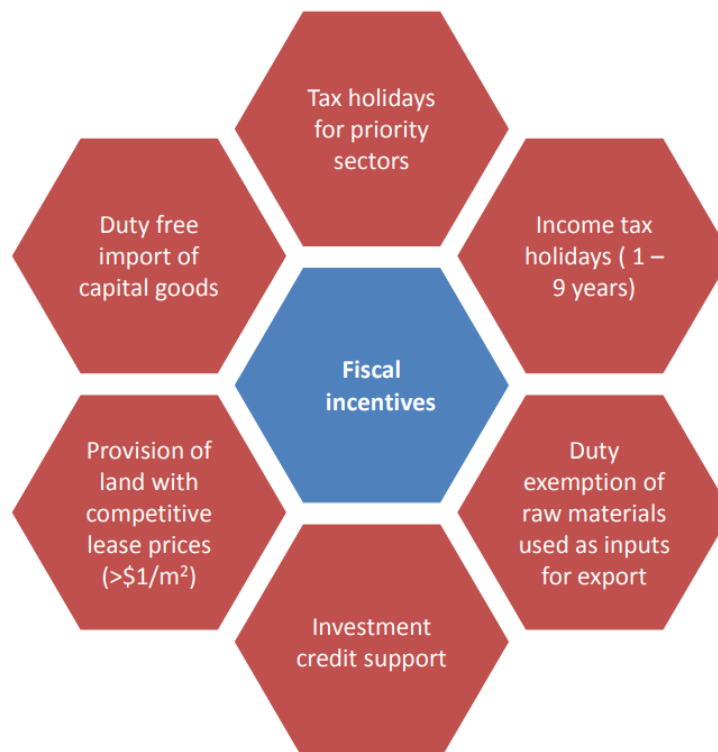
#### ***4.1.1.2. Investment Incentives Provided by Government of Ethiopia***

Ethiopia's investment admission policy has been modified more than four times in the last 22 years in favor of investors. Foreign investors can invest on their own or in partnership with domestic investors in areas open for Foreign Direct Investment (FDI). No restrictions on equity ownership in joint investment. Required to have investment permit from the EIC or relevant government organs as appropriate.

According to the latest Investment proclamation, proclamation no. 1180/2020, applicable to both domestic and foreign investors engaged in eligible new enterprises or expansion projects in manufacturing, agriculture, agro-industries, generation, transmission and supply of electrical energy, Information and Communication Technology Development (ICT), tourism, construction contracting, education and training, star designated hotel, specialized restaurant, architectural and engineering consultancy works, technical testing and analysis, capital goods leasing and importation of LPG and bitumen.

- 100% exemption from the payment of customs duties and other taxes levied on imports is granted to all capital goods, such as plant, machinery and equipment and construction materials
- Spare parts worth up to 15% of the total value of the imported investment capital goods, provided that the goods are also exempt from the payment of customs duties.
- An investor granted with a customs duty exemption will be allowed to import capital goods duty free indefinitely if his investment is in manufacturing and agriculture, and for five years if his investment is in other eligible areas.
- An investor entitled to a duty-free privilege who buys capital goods or construction materials from local manufacturing industries shall be refunded the customs duty paid for raw materials or components used as inputs to produce such goods.
- Investment capital goods imported without the payment of custom duties and other taxes levied on imports may be transferred to another investor enjoying similar privileges

**Figure 4: Fiscal incentives provided to investors**

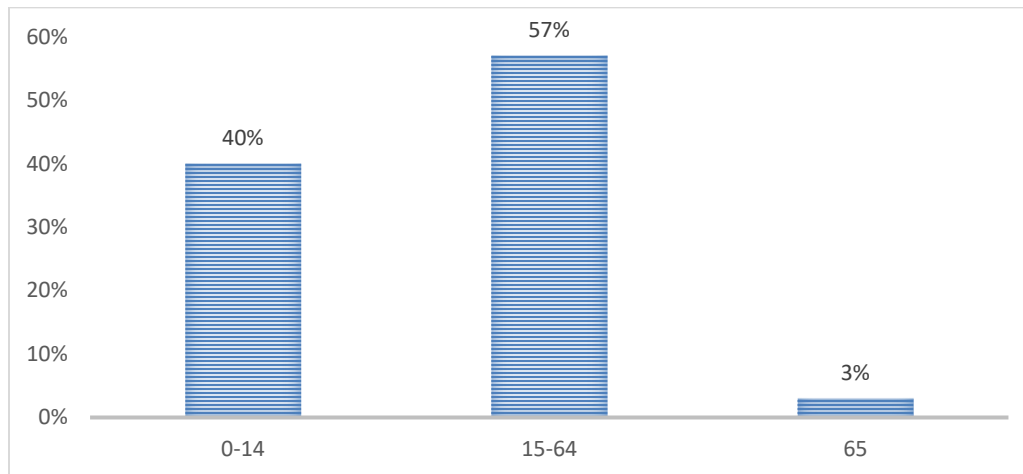


Source: EIC, 2021

#### ***4.1.1.3. Availability of cheap labour***

A bit shy of 60% of Ethiopia's population is in the working age group. Abundant, trainable, and industrious labor force. Labor cost in Ethiopia is relatively inexpensive even compared to regional average. Daily laborer costs less than \$5/day, Salaries of fresh university graduate is between \$110 – \$250/month.

**Chart 2: Ethiopia age classification**



**Source:** World data atlas Ethiopia demographics

#### **4.1.2. Challenges**

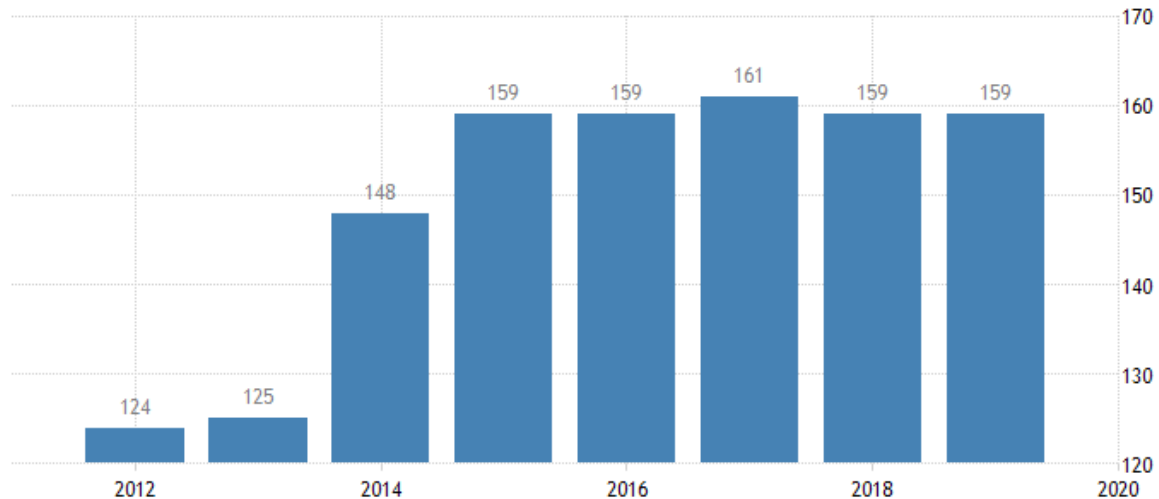
##### ***4.1.2.1. Challenges identified by Doing Business Ranking***

The Ease of doing business index ranks countries against each other based on how the regulatory environment is conducive to business operation stronger protections of property rights. Economies with a high rank (1 to 20) have simpler and more friendly regulations for businesses. Ethiopia is ranked 159 among 190 economies in the ease of doing business, according to the latest World Bank annual ratings. The following are major challenges identified by the WB doing business report concerning Ethiopia.

- Protecting minority investors, 189 out of 190 countries
- Starting a business, 168 out of 190 countries
- Getting credit, 176 out of 190 countries
- Dealing with construction permits, 142 out of 190 countries
- Registering Property, 142 out of 190 countries
- Getting electricity, 137 out of 190 countries
- Paying taxes, 132 out of 190 countries

Accordingly, the general doing business environment, despite the government continuous effort to improve the business environment is still considered as a challenge by many to engage and promote ISI.

**Chart 3 : Ethiopia doing business ranking 2012-2020**



*Source: World Bank, 2020, TradingEconomics.com*

#### **4.1.2.2. Challenges identified by global Investment and Credit rating agencies**

Major global investment rating agencies have examined current states of the country and gave one of the lowest rates in decades. This result is widely referred by global financing institutions and major investors who would potentially are expected to invest in Ethiopia's ambitious import substitution projects. The following are major challenges cited by this agency for giving such ranking.

- **A default events**
- **low levels of foreign reserves**
- **Increasing gross external financing needs**
- **The ongoing internal conflict**
- **Declining flow of external financing**

#### **4.2. Findings from primary data**

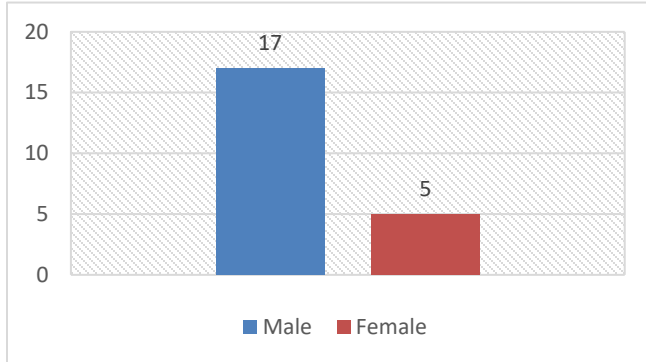
As stated on the methodology section of this chapter, Likert scale questioner was developed targeting key stakeholders identified above from both the sector associations and private sector. The questioner has two parts- the first part deals with general background on the interviewees and the second part deals with specific business-related questions. Based on the checklist prepared, the questioner was distributed to 30 respondents. Off the total, 24(80%) responses were filled out and collected back. From this, two responses were found incomplete and rejected.



#### 4.2.1. Demographic Characteristics

Regarding the demographic characteristics of respondents, the following graphs summarize it in terms of gender, educational level, industry type, legal for of the organization and years in business. With the intention of gathering only relevant background information, six demographic questions were raised which the researcher believed have direct correlation with the study.

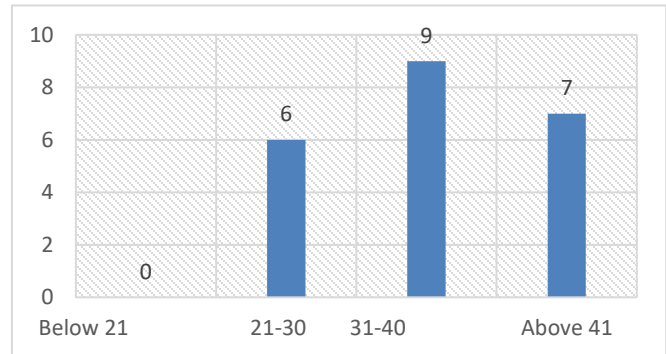
**Chart 4: Respondents by gender**



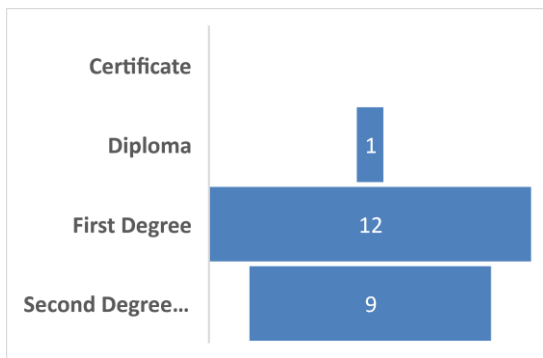
Regarding the sex of respondents 17(77%) were male while the rest 5(23%) were female.

**Chart 5: Respondents by age group**

Concerning age of respondents, majority of them, 9(41%), fell under the category of 30-40. 7(32%) were above 41 years followed by the age group 21-30 which was 6(32%). This implies that, the questionnaire was mostly filled by mid-level young executives and senior executives of responding organizations.



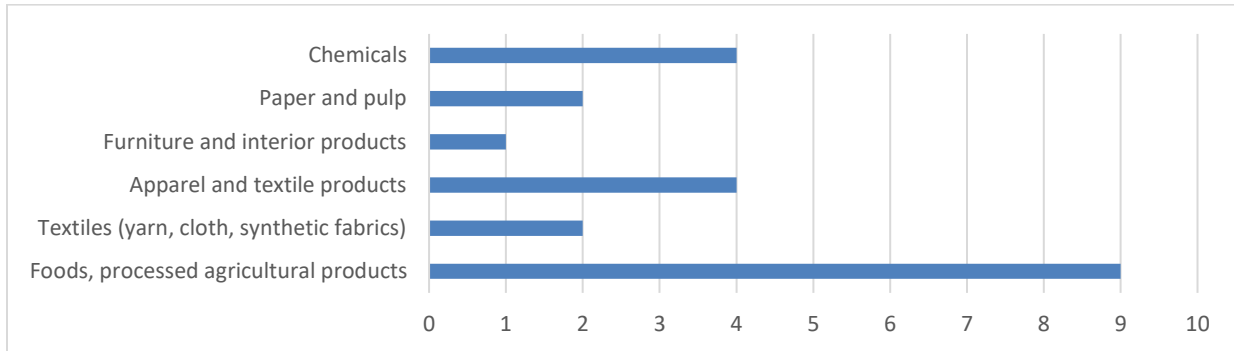
**Chart 6: Respondents by education level**



Concerning the education level of the interviewees, majority of them 12(55%) were first degree holders, followed by over second degree and diploma holders, 9(41%) and 1(5%) respectively.

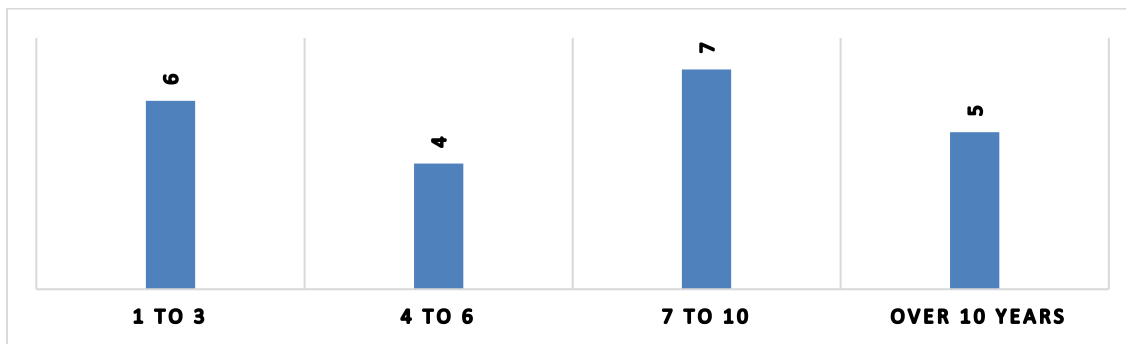
From this, the researcher assumed that the questionnaire and its intent was easily understandable by respondents and proper response was given accordingly.

**Chart 7: Respondents by industry**



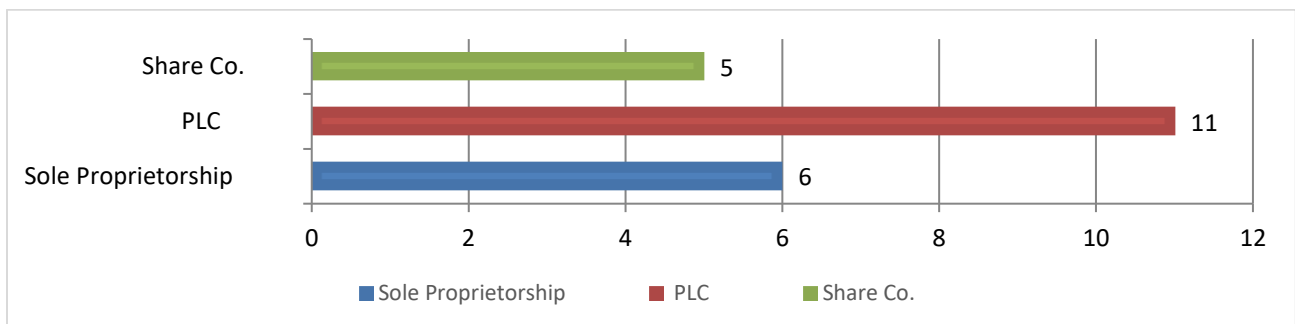
In terms of industry category of the respondents, 9(41%) of them were from food and agricultural products processing industries. 4(18%) were from apparel and textile industry, Textile (yarn, cloth, synthetic fabrics) 2(9%), Paper and pulp 2(9%) and 1 respondent from furniture and interior products industry.

**Chart 8: Respondents by years in business**



Regarding years in business, 32% of them have 7-10 years' experience, 6(27%) between 1-3 years of experience, 5(23%) of them above 10 years of experience and 4(18%) between 4-6 years of experience. In general, about 60% of the respondents have above 4 years of operation experience and they are considered as well fitted to talk about challenges and opportunities of ISI in Ethiopia.

**Chart 9: Respondents by legal business type**



About Legal form of the organizations, 11(50%) of them were incorporated as Private Limited Companies (PLC), 6(27%) of them Sole Proprietorship and 5(23%) as share company. Government parastatals were targeted for this survey originally. However, the researcher couldn't be able to include their response due to their closed doors to provide information.

#### 4.2.2. Analysis of Investment, Operation & Business-related issues

On this section, 8 Likert scale questions were listed and respondents were asked to choose Definitely if they Strongly support; Probably if they Agree; Possibly if they are in neutral position; Probably Not if they disagree and Definitely Not if they strongly object and rate each factor to what extent from very high to very low and tick (√) the number which closely represents their opinion around one of the five digits, 1, 2, 3, 4, and 5.

##### 4.2.2.1. Analysis on general investment climate and government support

<b>General investment climate &amp; government support</b>	<b>Definitely Not (1)</b>	<b>Probably Not (2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
Government has clear policy to support import substitution industry	0%	0%	0%	18%	82%
Starting & doing business in Ethiopia is an easy not that difficult	0%	50%	32%	18%	0%
Government has attractive incentives for those who wanted to engage in import substitution industries	0%	0%	0%	77%	23%
Government sufficiently protects & closely support import substitution industries	0%	18%	68%	14%	0%
Complicated administrative procedures (to acquire permits, etc.)	0%	0%	0%	14%	86%

The general business and investment climate of a country is one of the major factors determining the level of industrialization. According to this research survey result, 88% of respondents strongly believes that Ethiopia has clear policy to support import substitution industry. This was also supported by secondary data reports made by different institutions as we have seen in the previous section. However, only 18% of respondents some how agree that doing business in Ethiopia is an easy task. 50% of respondents say starting and doing business in Ethiopia is difficult while 32% of them remain neutral about this. When it comes to incentives provided by the government, 77% of them somehow agreed that GoE provided sufficient incentive while 23% of them strongly support the statement. When it comes to protection and close support provided by the government to import substitution industries, majority of them, 68%, hold neutral position, while 18% of them disagree on the statement and the rest 17% somehow agreed that government is providing sufficient protection and support to import ISI.

Finally, regarding administrative procedures, 86% and 14% of them strongly and somehow strongly agreed that administrative procedures in Ethiopia are complicated.

#### 4.2.2.2. Challenges in the investment environment

Challenges in the investment environment	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Unstable or insecure political or social conditions	0%	0%	0%	0%	100%
Underdeveloped infrastructure (electric power, transportation, communications, etc.)	0%	27%	55%	18%	0%
Complicated tax procedures	0%	9%	32%	23%	36%
Undeveloped economic and legal systems, and arbitrary application of the legal system	0%	0%	9%	14%	77%
Restrictions on foreign investment including restrictions on foreign capital ratio	0%	27%	0%	18%	55%

100% of respondents agreed that unstable and insecure political and social condition in the country has been a threat to their investment. This was also reflected in the reports of major global rating agencies reports as discussed previously. In terms of infrastructure, 50% of respondents hold neutral position on sufficiency of such major services while 18% of them somehow agreed that infrastructure is underdeveloped to support ISI and the rest 27% somehow believed existing infrastructure in the country is sufficient to run ISI. When it comes to tax procedure, 36% of respondents strongly agreed that the procedure is complicated while 22% of them say it is moderately complicated. Both combined, it implies that tax procedure in Ethiopia in general is complicated.

When we see the legal and arbitrary system, 77% of respondents believes that the system is underdeveloped while 14% of respondents somehow agreed that the system is underdeveloped. The remaining 9% remain neutral on this. Regarding restrictions on foreign investment including restrictions on foreign capital ratio, 50% of them strongly agreed and 18% of them moderately agreed that restriction is a challenge to intensify ISI in Ethiopia. Contrary to this, 27% of respondents see the restriction having only moderate effect on ISI.

Again, most of the reports that have referenced above, and government investment regulation has put several restrictions on foreign investment which was criticized by institutions such as World Bank and IMF while the GOE justifies its action as protection of local investors not to be swarmed by giant conglomerates from abroad.

#### 4.2.2.3. Analysis on production and operation issues

Challenges in production are due to	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Increase in procurement costs	0%	0%	0%	0%	100%
Difficulty in local procurement of parts and raw materials	0%	0%	0%	18%	82%
Difficulty to get quality & standardized products	0%	0%	14%	27%	59%
High customs duties on imported capital goods and intermediary goods	0%	18%	9%	23%	50%
Stricter environmental regulations	100%	0%	0%	0%	0%

Analysis of operation related issues revealed that increasing procurement cost is the major issue which 100% of respondents shared unanimously. Difficulty in getting parts and raw materials from local market is another serious challenge agreed by 82% of respondents while 18% of them cited this as a moderate challenge. In terms of getting quality and standardized products from local market, 59% of them sees it as major problem, 27% as moderate problem while 14% of them choose neutral position. About customs duties on imported capital and intermediary goods, 50% and 23% of respondents respectively believed that the tariff is enormously and moderately high. On the matter of stricter environmental regulation, 100% of respondents agreed that its not a problem now affecting their operations.

#### 4.2.2.4. Analysis on financial affairs, financing, or foreign exchange

Challenges in financial affairs, financing, or foreign exchange	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Shortage of cash flow necessary for capital investment	0%	0%	14%	45%	41%
Difficulty in procuring funds from local financial institutions	0%	0%	0%	23%	77%
Accessability & Volatility of local currency's exchange rate against the US dollar	0%	0%	0%	0%	100%
High tax burdens (i.e. corporate taxes and transfer pricing taxes)	0%	0%	5%	27%	68%

Shortage of cash flow for capital investment is another challenge identified in which 41% of respondents consider it as major issue whereas 45% of them see it as a moderate challenge. In terms of access to finance, 77% of respondents have serious challenge accessing loan from financial institutions while 23% of them put it as a moderate challenge. Accessibility and volatility of local currency against US dollar is another serious issue where 100% of respondents flagged as a challenge for manufacturing industry.

This issue was also cited as a major challenge by the different reports and analysis which were referenced in the previous sections. Regarding tax burdens, 68% of them strongly agreed that tax levied on them is too high while 27% of them say its moderately high.

#### 4.2.2.5. *Analysis on human resource*

Challenges with labor or employment	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Increase in employee wages	0%	27%	32%	41%	0%
Difficulty in recruiting general staff	36%	45%	18%	0%	0%
Difficulty in recruiting management staff	0%	23%	0%	32%	45%
Difficulty in recruiting engineering staff	0%	23%	0%	41%	36%
Low rate of worker retention	0%	0%	0%	36%	64%
Restrictions on staff dismissal and reduction	27%	36%	14%	23%	0%

Analysis of human resource reveals that increasing in employee wages is a moderate challenge for 41% of respondents while 27% of them somehow disagree that increasing wage is challenge for their operation. In terms of recruitment, 36% of respondents didn't consider recruitment of general staff as a challenge whereas 45% of them see it as a minor challenge. 18% of them remain neutral on the same. When we see recruitment of management staff, 45% of them see this as a major challenge and another 32% of them see it as a moderate challenge. The remaining 23% of respondents disagree to consider recruitment of management staff as a challenge. Regarding engineering staff recruitment, 36% and 41% of respondents strongly and moderately agree respectively that it's a challenge. However, 23% of respondents somehow disagree to consider recruitment of management staff as a challenge. In terms of workers retention, 64% of respondents strongly agree that it's a major challenge while 36% of them moderately agree on the seriousness of the issue. Finally, 27% and 36% of respondents strongly and moderately disagree that restrictions on staff dismissal and reduction as challenge to their business. Contrary to this 23% of them consider the issue creating moderate challenge on their business. 14% of respondents remain neutral on the same.

#### 4.2.2.6. Analysis on ratio of local raw materials and parts to manufacture major items

What is the ratio of local raw materials and parts to manufacture major items by your company?	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Less than 50%	0%	0%	0%	0%	64%
50% to less than 60%	0%	0%	0%	0%	23%
60% to less than 70%	0%	0%	0%	0%	0%
70% to less than 80%	0%	0%	0%	0%	14%
80% to less than 90%	0%	0%	0%	0%	0%
90% or above	0%	0%	0%	0%	0%

**Note:** Respondents were asked to select one that applies for their organization

When we see the ratio of local raw materials and parts used to manufacture major items, 64% of them source half of the raw material from local sources. The other 23% source up to 60% of their raw material from local sources and only 14% of them (most of them are food processing companies) source up to 80% of raw material from local source.

#### 4.2.2.7. Analysis of factors that leads to increased local procurement of raw materials

What factor(s) is necessary to increase local procurement ratios of raw materials and parts?	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Quality improvement by local suppliers	0%	0%	0%	0%	100%
Cost reduction by local suppliers	0%	0%	23%	77%	0%
Strict observance of delivery dates by local suppliers	0%	0%	0%	0%	100%
Improvement in the local logistical and transportation infrastructure	0%	0%	0%	18%	82%
Expansion of affiliated suppliers into the local area	0%	18%	9%	73%	0%

Improving quality of local raw materials is the major issue which all respondents strongly agreed needs to be changed to increase share of local supply sourcing. Regarding cost, 77% of respondents somehow agreed that cost of local raw materials is high and needs to be reduced while 23% of them remain neutral on this. When it comes to respecting delivery dates, 100% of respondents agreed this as a major challenge that's needs to be corrected. Improvement in the local logistical and transportation infrastructure is another challenge where 82% and 18% of respondents see as serious and moderate challenge for the industry. Again, 73% of respondents believed that expansion of affiliated suppliers into the local area may improve local sourcing of raw materials while 18% of them somehow disagree on the same.

#### 4.2.2.8. Analysis on business Outlook

Compared to the previous year, operating profit for 2022 (January to December) is expected to increase if there is	Definitely Not (1)	Probably Not (2)	Possibly (3)	Probably (4)	Definitely (5)
Reduction in procurement costs	0%	0%	0%	0%	100%
Reduction in personnel expenses	0%	0%	0%	0%	100%
Improved production efficiency	0%	0%	59%	41%	0%
Initiation/expansion of production of high value-added products	64%	36%	0%	0%	0%
Increase in sales	0%	27%	14%	41%	14%

Respondents were asked about factors that may lead to profitability of their businesses in the short term. Accordingly, 100% of them sees reduction in procurement cost of raw materials and personal expenses are key if desired level of profit is sought. Again, 59% of respondents were skeptical about if improving production capacity can brought change on their profits. In addition to this, 64% of respondents don't have any immediate plan to expand their production or introduce new business lines soon. Finally, 41% and 14% of respondents strongly and moderately agreed that profit can be secured in the near future if sales increase. Contrary to this, 28% of respondents moderately disagree that increase in sales can bring profitability in the short run. The remaining 14% remain neutral on the same.

### 4.3. Discussion on identified Opportunities and Challenges

#### 4.3.1. Opportunities

Findings of this research clearly indicates that effective implementation of ISI would play significant role in creating employment opportunities, support the nations ambition of poverty reduction, support sustainable development of agriculture by use of domestic raw materials and labor, reduction of foreign exchange spending, create a strong foundation for the industrial sector to start playing a leading position in the national economy as well as technology and knowledge transfer.

Regarding policy and sector support, various secondary documents, and analysis of respondents of this research (82%) strongly agreed that GoE has clear policy and strategy to support import substitution industry. *In its Home-Grown Economic Agenda (2020), GoE puts a vision to make Ethiopia a middle-income country and Leading manufacturing hub in Africa by 2025. Ghebreyesus(2008) also asserted that Ethiopia is also one of the few African countries to have formulated full-fledged industrial policy and has been aggressively pursuing it.*

*The latest investment law enacted in 2020 listed down all fiscal and non-fiscal investment incentives such as generous credit schemes, exemption from the payment of duties on import of all investment capital goods and raw materials necessary to produce export goods, and tax holidays on profit for five years are granted for certain categories of investors to promote and*



*facilitate private investors to play their role in investing and accelerating the country's economic growth. Almost 100% of respondents of the questionnaire agreed that Ethiopian government has put attractive admission and regulatory incentive schemes in place for local and foreign investors by way of supportive legal, institutional, and incentive environment that stimulate investors entering investment ventures.*

*Industrial Parks Development Corporation of Ethiopia (IPDC) is mandated to develop and operate a wide range of industrial parks. Several industrial Parks are being developed throughout the country to support the policy of ISI.*

*When it comes to demand, according to EIC, Ethiopia being one of the most populous nations, there is a huge unsatisfied domestic demand. High rate of population growth and continued urbanization, increasing demand for food, agricultural and manufactured products. Ethiopia's geographic and demographic realities present excellent opportunities for investment and trade. According to UNDP(2020) report, a bit shy of 60% of Ethiopia's population is in the working age group at relatively cheaper wages (payments). However, , technological gap in the form of tacit knowledge is reflected in the delay of many of the public enterprise projects that were awarded to the domestic firms. 82% of respondents confirmed that employing general staff isn't a problem at the moment.*

#### **4.3.2. Challenges**

*Despite GoE policy on providing extraordinary support to ISI, complicated administrative procedures and bureaucracy at implementation level for instance to acquire permits, land etc are constantly mentioned as major challenges. The WB 2020 doing business report confirmed Ethiopia's low doing business global ranking to attract potential foreign investors to engage in ISI. Almost 100% of respondents agreed on the existence of complicated administrative procedures which the researcher consider the major challenge faced by ISI. According to (Oqubay, 2018), Many policy instruments, however, have not been entirely effective. First, most of the export-promotion schemes required effective coordination, automation of the customs system, and qualified professional staff, but these were often lacking. Second, sectoral institutes set up to support priority sectors were unable to attract staff with the professional skills, qualifications, and experience required to support firms.*

*100% of respondents agreed that unstable and insecure political and social condition in the country has been a threat to their investment. This was also reflected in the reports of major global rating agencies reports as discussed in the previous chapters. In the 2020 WB doing business report, Ethiopia ranked 189 out of 190 countries in terms of protecting minority rights.*

Prevalence of underdeveloped infrastructure (electric power, transportation, communications, etc.) is another challenge faced by ISI. The current condition in Ethiopia showed that the power supply is severely below the required amount for medium as well as large scale industries. The result also showed that despite the country's effort in building hydroelectric dams and other renewable power generation stations, the country still suffers from shortage of electric power supply. Kaplan (2009) also argued that electric power supply is one of the modern requirements of manufacturing industries. Connection to electrical grids is vital to the existence of these industries. According to Maritz, Internet connections have been so weak, and interruptions are rife. Not only are firms constrained in making online transactions, but also face transaction costs in making transfers through banks, paying bills, and paying taxes when the internet is down at such service points.

In terms of challenges in the investment environment, undeveloped economic and legal systems, and arbitrary application of the legal system, restrictions on foreign investment including restrictions on foreign capital ratio and complicated tax procedure are the major challenges identified by respondents of the questioners. Unstable or insecure political or social conditions is another serious challenge affecting ISI which 100% of respondents agree on. This has also been cited by global agencies such as Fitch, who measure risk of countries on investment and finance.

Challenges in operation/production are mostly associated with high dependency of ISI on imported raw material and parts due to difficulty in local procurement of parts and raw materials. About 86% of respondents agreed that local raw material supply is insufficient and non-standardized. Most raw materials and inputs are imported with long lead time which tie up operation. About 36% of respondents use over 50% imported raw material for their operation. Getting quality and standardized products at the right time and quantity is another challenge faced by all respondents. High customs duties on imported capital and intermediary goods, soaring price of inputs for production, low level of foreign exchange to import raw material, machineries and parts on time are major challenges identified by this research. The 2020 UNDP report proclaimed that there are three aspects of the problem related to the domestic raw materials constraint: shortage, seasonal supply, and poor quality.

When it comes to access to finance, *accessibility, and Volatility of local currency's exchange rate against the US dollar has also been cited as a major challenge almost by all respondents. The same challenge was admitted by GoE in its new home growing economic reform agenda. According to Maritz (2020), the unpredictable supply of raw materials – due to foreign currency shortages, transport delays and inadequate local production – makes it difficult for*

*manufacturers to plan for expansion of their operations, despite the clear market opportunity.* Shortage of cash flow necessary for capital investment (low liquidity) was one of the challenges which 86% of respondents agreed on. Difficulty in obtaining funds from local financial institutions is another serious challenge which 100% of this research respondents agreed on. Human resource availability was another factor explored in this study. *According to the 2020 UNDP report, there is huge skill and technological gaps in addition to capacity gaps such as finance in Ethiopia manufacturing sector.* While 82% of respondents indicated that they don't have difficulty in recruiting general staff, recruiting management and engineering staff has been identified as a challenge by 77% of respondents. 64% of respondents strongly consider low rate of worker retention as a challenge faced by ISI.

When asked about future business outlook, it seemed most of the respondents were pessimist about the future and strongly believe that profitability would be gained if reduction in personnel and procurement costs attained. None of the respondents have any immediate plan to initiate expansion of production of high value-added products. Only 41% of them believe that innovation and increased efficiency bring profit in the curet situation.

Overall, respondents of the questionnaire suggested the following which they believe may improve performance of ISI in short and medium period such as Quality improvement by local suppliers(100%), Cost reduction by local suppliers(77%), Strict observance of delivery dates by local suppliers(100%), Improvement in the local logistical and transportation infrastructure (82%), Expansion of affiliated suppliers into the local area(73%).

## **CHAPTER FIVE**

### **CONCLUSION AND RECOMMENDATIONS**

#### **5.1. Conclusions**

From the presentation of findings and the discussion made above the following conclusions can be made:

- Ethiopian government has taken various initiatives to encourage local and international investors to manufacture imported products locally and decrease the countries dependence on developed countries by providing fiscal and nonfiscal incentives including construction of industrial parks, by subsidizing prominent industries and putting in place protectionist trade policies. However, some argued that all these initiatives were done at the expense of citizens for few and need to be consider carefully not to be abused by irresponsible stakeholders.
- Though GoE has clear policy on industrialization and ambition to substitute most imported products from abroad, bureaucratic red tape and implementation of such policies on the ground poses a challenge on the Ethiopian import substitution industrialization policy. Low-capacity and motivation of implementing public offices on the ground frustrates industrialists and this puts the country on low level of doing business performance ranking globally.
- Majority of ISI industries are still dependent on imported raw materials not to mention the machinery itself and their accessories. This poses a question; weather IS industries in Ethiopia are truly important to bring the desired level of structural transformation so long as majority of the components and raw materials are continued to be imported from abroad.
- Despite abundant labor force, getting qualified management and engineering personal suited for industry. High employees' turnover is another challenge for ISI in Ethiopia.
- Burdensome customs administrative procedures, the high cost of logistics, and access to credit and foreign exchange are major challenges to ISI in Ethiopia.
- On the other hand, improved road network, the developments of industrial parks, the presence of telecommunication network and the presence of various economic incentives are found to be the major opportunities of import substitution industrialization in Ethiopia.
- Fragile security situation in the country was a problem for many industrialists to focus on what they are doing and be optimistic about the future.

## 5.2. Recommendations

Based on findings of the study, the following recommendations are forwarded.

GoE should put in place systematic accountability measures and service level agreements to improve the country's ease of doing business practice especially the bureaucratic procedures to get license, construction permits, land, customs clearance, paying tax and getting basic infrastructures such as electricity. Rent seeking behavior of some civil servants in almost every major service giving government office is another challenge that the government should put in place such as allowing open door policy to report wrong doings. Stable political environment, peace and security is another major issue that the government must ensure to attract new investment and encourage existing ones to operate at their efficiency without fear of any possible hazard arising due to this.

Regarding incentives and protection, rather than blindly supporting every ISI, the government should install mechanism to evaluate competitiveness and cost benefit of each sector before providing huge incentives to investors. Competitiveness of the sector can be evaluated by using different mechanisms such as availability of raw material in country, labor force requirement, percentage of raw materials needed from foreign sources etc. To reduce dependency on imported raw materials, government must encourage private companies and other stakeholders to invest in local raw materials supply chain to produce more such as agricultural products or improving efficiency of sourcing and by modernizing supply chain for the manufacturing sector.

Access to finance is another critical problem industries face in Ethiopia. Accordingly, the government need to have clear policies and strategy to alleviate the problem of shortage of finance manufacturers face to fund capital goods, raw material purchase and capacity enhancement. This can be achieved if the government allow foreign banks to operate in Ethiopia or by encouraging private financial institutions to operate in the desired level of competitiveness. Another recommendation is to have mandatory minimum portfolio lending say 10% or 15% by each commercial banks specific to ISI.

To address the issue of skilled manpower, both government and private learning institutions should consult with industries to identify key skilled manpower gaps for subsector and design strategy accordingly to address the challenge through their regular programs as well as by designing tailored made short- and medium-term trainings.

Finally, the researcher strongly believes that ISI has immense potential in creating job opportunity, technology transfer, bringing social changes and reducing the current critical shortage of foreign currency arising from huge trade deficit if implemented carefully by taking into consideration the recommendations forwarded above.

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## Annex

# Questionnaire

## St. Mary's University School of Graduate Studies

### Challenges and opportunities of import substitution in Ethiopia

Dear respondent:

This questionnaire is developed for academic purpose to gather information for the partial fulfillment of the Master of Business Administration (MBA) Program at St. Mary's University. This survey is conducted to investigate challenges and opportunities of import substitution in Ethiopia and features of import substitution policy, mechanisms of import substitution policy in Ethiopia, existing potential, cost benefit analysis and the concept of "import substitution" which results in import substitution policies that increase volume and share of goods produced within the territory of the country.

The questionnaire has two parts- demographic and general background questions and Likert scale question about your organization business and operation respectively.

The information gathered through this questionnaire will be used by the student researcher conclusively for academic purpose. Please take your time and complete the questionnaire completely and honestly. Your responses will be kept confidential.

If you should have any questions regarding the survey, you can reach out to me at any time by using the below contact details.

Bisrat Ermias

Tel: +251911601061 E-mail: [bisrat.ermias@gmail.com](mailto:bisrat.ermias@gmail.com)

**Thank you in advance for your cooperation!!**



## PART I- Demographic and Background Information

- Please mark only one response to a question, unless other direction is given
- Put (✓) inside the box which you think is correct.

1.1. Sex:

Male       Female

1.2. AGE:

Below 21       21-30       31-40       Above 41

1.3. Educational Background:

Certificate       Diploma       First Degree       Second Degree and above

1.4. Industry: Please choose an industry from the list below.

- Foods, processed agricultural products
- Textiles (yarn, cloth, synthetic fabrics)
- Apparel and textile products
- Furniture and interior products
- Paper and pulp
- Chemicals

1.5. Legal form of your organization (company)

Sole Proprietorship     PLC     Share Co.     Other please specify \_\_\_\_\_

1.6. Years in business

1-3       4-6       7-10       Over 10 years

## PART II: Investment, Operation and Business-related questions

This section 9 Likert scale questions. Read each item carefully. Choose **Definitely** if you Strongly support; **Probably** if you Agree; **Possibly** if you are in neutral position; **Probably Not** if you disagree and **Definitely Not** if you strongly object. Please rate each factor to what extent from very high to very low and tick (v) the number which closely represents your opinion around one of the five digits, 1, 2, 3, 4, and 5.

<b>Questions about Business Problems</b>						
<b>1</b>	<b>General investment climate and government support</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
1.1	Government has clear policy to support import substitution industry					
1.2	Starting & doing business in Ethiopia is an easy not that difficult					
1.3	Government has attractive incentives for those who wanted to engage in import substitution industries					
1.4	Government sufficiently protects and closely supports import substitution industries					
1.5	Complicated administrative procedures (to acquire permits, etc.)					
<b>2</b>	<b>Challenges in the investment environment</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
2.1	Unstable or insecure political or social conditions					
2.2	Underdeveloped infrastructure (electric power, transportation, communications, etc.)					
2.3	Complicated tax procedures					
2.4	Undeveloped economic and legal systems, and arbitrary application of the legal system					
2.5	Restrictions on foreign investment including restrictions on foreign capital ratio					
<b>3</b>	<b>Challenges in production are due to:</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
3.1	Increase in procurement costs					
3.2	Difficulty in local procurement of parts and raw materials					
3.3	Difficulty to get quality & standardized products					
3.4	High customs duties on imported capital goods and intermediary goods					
3.5	Stricter environmental regulations					
<b>4</b>	<b>Challenges in financial affairs, financing, or foreign exchange</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
4.1	Shortage of cash flow necessary for capital investment					
4.2	Difficulty in procuring funds from local financial institutions					
4.3	Accessibility & volatility of local currency's exchange rate against the US dollar					
4.4	Tax burdens (i.e. corporate taxes and transfer pricing taxes)					
<b>5</b>	<b>Challenges with labor or employment</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
5.1	Increase in employee wages					
5.2	Difficulty in recruiting general staff					
5.3	Difficulty in recruiting management staff					
5.4	Difficulty in recruiting engineer staff					
5.5	Low rate of worker retention					
5.6	Restrictions on staff dismissal and reduction					
<b>Questions about Procurement of Raw Materials and Parts</b>						

<b>6</b>	<b>What is the ratio of local raw materials and parts to manufacture major items by your company?</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
6.1	Less than 50%					
6.2	50% to less than 60%					
6.3	60% to less than 70%					
6.4	70% to less than 80%					
6.5	80% to less than 90%					
6.6	90% or above					
Note: Please select one that applies for your organization						
<b>7</b>	<b>What factor(s) is necessary to increase local procurement ratios of raw materials and parts?</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
7.1	Quality improvement by local suppliers					
7.2	Cost reduction by local suppliers					
7.3	Strict observance of delivery dates by local suppliers					
7.4	Improvement in the local logistical and transportation infrastructure					
7.5	Expansion of affiliated suppliers into the local area Other (					
<b>Questions about Business Outlook</b>						
<b>8</b>	<b>Compared to the previous year, operating profit for 2022 (January to December) is expected to increase if there is</b>	<b>Definitely Not (1)</b>	<b>Probably Not(2)</b>	<b>Possibly (3)</b>	<b>Probably (4)</b>	<b>Definitely (5)</b>
8.1	Reduction in procurement costs					
8.2	Reduction in personnel expenses					
8.3	Improved production efficiency					
8.5	Initiation/expansion of production of high value-added products					
8.6	No change is expected from the previous year					
8.7	Reduction in sales due to exchange rate fluctuations					

**Thank you!**