

Foreign Direct Investment and Labor Market Dynamics in a Developing Country: Evidence from Indonesian Plant-Level Data[§]

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Abstract

We examine the impact of inward foreign direct investment (FDI) on employment in local firms in Indonesia. Indonesia experienced a significant inflow of FDI after the Asian financial crisis. A rise in FDI is expected to increase the labor demand of local firms through externality. However, labor-market competition also becomes severe, particularly for skilled workers due to the skill-biased labor demand of multinational enterprises (MNEs). While these two effects predict wage growth, they have opposite impacts on employment. Thus, results from previous studies that examine FDI's impact on the wages or productivity of local firms do not allow us to assess its impact on employment. Employing microdata from Indonesian manufacturing, we find that the entry of MNEs induces local firms to hire more unskilled workers but fewer skilled ones. As a result, the skill intensity of local firms declines, which reduces their innovation potential and their capacity to absorb the externality effects of MNEs. Our results suggest that the supply of skilled workers is key to the growth of Indonesian manufacturing.

Keyword: Foreign Direct Investment, Resource reallocation, Skill intensity

JEL classification code: F23, J24, O14

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