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FOREIGN DIRECT INVESTMENT AND UNEMPLOYMENT NEXUS IN INDONESIA: VECM ANALYSIS

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ABSTRACT

The population of Indonesia was about 261 million people in 2018. As a heavily populated country, unemployment is bound to be a problem in Indonesia. Foreign direct investment is considered to have a crucial role in reducing the unemployment rate. This study examines the significance of Foreign Domestic Investment (FDI) for reducing the unemployment rate in Indonesia. Johansen Cointegration technique and Vector Error Correction Model (VECM) have been used on time series data ranging from 1991-2017 to assess the relationship in the short and long term between Foreign Direct Investment (FDI) and Unemployment Rate. The results suggest that a strong positive long-run relationship exists between Foreign Direct Investment (FDI) and Unemployment. Therefore, the government of Indonesia should pay attention to all aspects related to the FDI domain when they intend to design policies with the purpose of reducing the unemployment.

KEYWORDS

foreign direct investment, unemployment, vector error correction model.

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1. INTRODUCTION

Unemployment is one of the most important problems in developing countries including Indonesia. The total population of Indonesia was over 261 million people in 2018. Bureau Statistic of Indonesia published that 133.9 million of the Indonesian population is the labor force. According to this publication, the unemployment rate was around 5.1 % of the labor force in 2018.

In recent years, numerous researchers have conducted studies about the relationship between unemployment, investment, economic growth, and other factors. Their studies have considered and examined the effects of undertaken measures for reducing unemployment. The studies have many discussions about how the foreign direct investment may be a possible solution to unemployment and economic growth. Several literatures found that Foreign Direct Investment is positively related to gross domestic production (GDP), meaning that an increase in FDI will boost the economy.

Along with this, FDI could help reduce the unemployment rate. FDI on the employment can be identified have a positive impact when the investment supplement to domestic investment and involves the creation of new factories (greenfield plants), in this condition, the demand for labor will tend to increase. FDI also can cause increased employment among local businesses as a result of backward or forward linkages in order that direct employment by using foreign affiliates might also underestimate the whole effect. There will also be spillovers for domestic firms due to training by foreign investors or technology transfer. Foreign firms that are subject to pressure in their home countries can also bring with them a higher standard of labor and wage than the norm for the host economy. If a company makes a long-term commitment, it can supply firm employment.

However, FDI also has a negative effect on employment. This can replace local investments so that the net effect on employment is lower than the amount directly employed by foreign affiliates. Where FDI involves the acquisition of a local company rather than a new company, there is no early increase in employment; if the foreign owner then rationalizes the company, the employment even tends to decline. Often, FDI is concentrated in capital-intensive industries so that employment is created low. In addition, there may be some local relationships if most of the inputs used by foreign affiliates are imported and this is a share in the local economy. The job created is possible for a relatively skilled workforce rather than for the unskilled who are oversupplied. If the investment is on footloose and can easily move to an alternative location, then the jobs are likely to be very unstable.

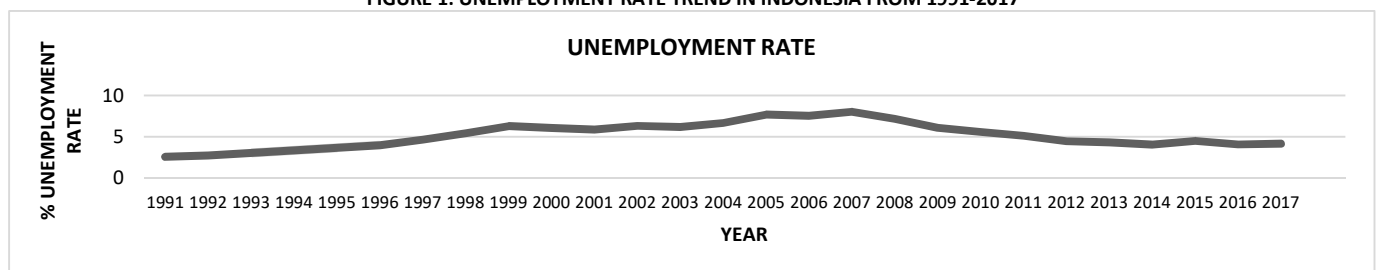
Thus, the question about relations between foreign direct investment and unemployment makes a very important and interesting scientific problem. The aim of this paper is to investigate the links between the unemployment rate and FDI and in Indonesia over the period 1991-2017.

The structure of the paper is as follows: section one which dealt with the introduction and research objective. Section two illustrates overview of FDI and Unemployment rate in Indonesia, section three focuses on reviews of relevant literature. In section four presents the data and presents research methodology. Section five provides results findings of the study. Lastly, section six presents the conclusion.

2. OVERVIEW OF FDI AND UNEMPLOYMENT RATE IN INDONESIA

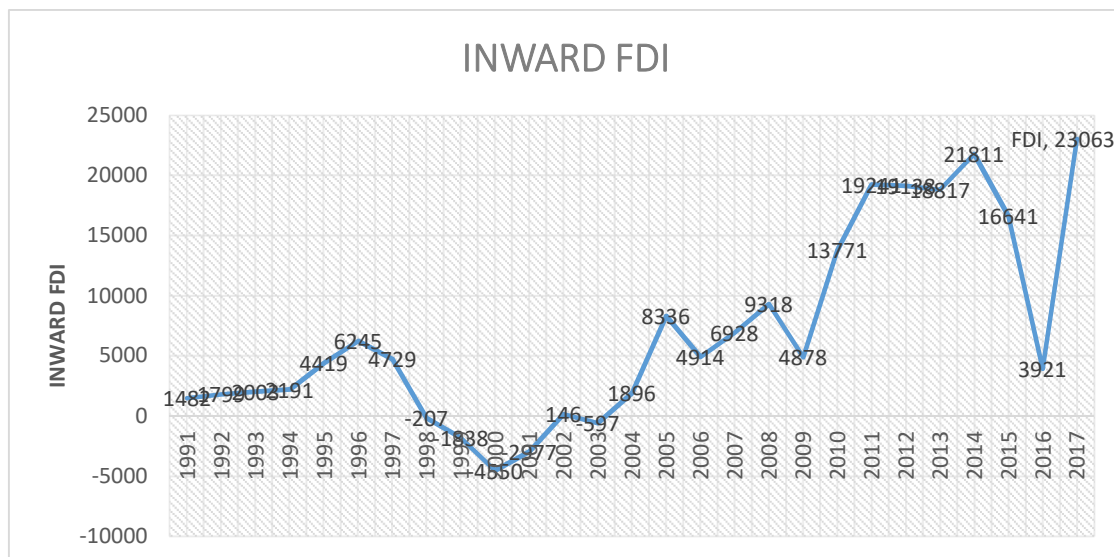
Data obtained on the unemployment rate in Indonesia from the period 1991 - 2017 fluctuated. Based on Figure 1, the amount of unemployment rate at 1991 was 2.59 percent, and it increased continually to 10.75 percent in 2005. However, since 2005 it gradually decreased to 4.18 percent in 2017.

FIGURE 1: UNEMPLOYMENT RATE TREND IN INDONESIA FROM 1991-2017



Source: World Bank

FIGURE 2: INWARD FDI TREND IN INDONESIA FROM 1991-2017



Source: World Bank

Figure 2 shows Inward FDI in Indonesia from 1998 to 2001, that FDI in Indonesia was a deficit. This is due to the global crisis that has an effect on investment in Indonesia. But since 2002, the foreign direct investment has continued to increase. This amount in 2017 exceeded US \$ 23,063 million even though in 2016 it was only US \$ 3,921 million.

3. LITERATURE REVIEW

Many economy literatures have extensively examined the inflow of FDI to show its effects on the labor market. There are many studies which conclude that FDI positively affects the employment level of an economy. Many of these studies also highlight the role that FDI plays to boost economic growth. He (2018) undertook a study to examine the interaction among foreign direct investment, economic growth and employment in China that applies data from 1983 to 2016. He used three variables to conduct an empirical analysis under the VAR model. The result of this study showed that foreign direct investment has a positive effect on economic growth and employment, and that economic growth has a positive effect on employment. The employment and economic growth happened to be bidirectional causality. According to this study, foreign direct investment increases employment.

Likewise, concerning the Malaysian economy, Shaari, Hussain, and Halim (2012) examined the impact of foreign direct investment (FDI) on the unemployment rate and economic growth in Malaysia during 1980 to 2010 using ordinary least squares method to analyzed the data. Their study found that FDI helped reduce the unemployment rate and increased the gross domestic product (GDP) in Malaysia. Similarly, Irpan et al. (2016) examined the impact of FDI on the employment rate in Malaysia. The study used annual data spanning from 1980 to 2012. Autoregressive distributed lag (ARDL) model is used to determine the long run relationship between the variables. The study showed that FDI, the number of foreign workers, and GDP significantly influence the unemployment rate in Malaysia.

Stamatiou and Dritsakis (2014) analyzed the relationship between unemployment rate, foreign direct investments and economic growth in Greece using annual time series data for the period 1970 to 2012. This study applied several econometric models, including the bounds testing (ARDL) approach and ECM-ARDL model. These results offer new perspectives and insight for new policies for sustainable economic development, increasing investments and reducing the unemployment. Balcerzak and Zurek (2011) investigated the relationship between FDI and unemployment in Poland using the VAR methodology to analyzed data. This study finds FDI impulse leads to decreasing of the unemployment rate.

Palat (2011) research aimed to evaluate of inward FDI flows into the Japanese economy and unemployment development. Methods of regression and correlation analysis (including testing the statistical significance) were used in the analysis of FDI and unemployment. This study showed that the correlation between FDI and the rate of unemployment has been approved.

The direct impact of FDI on employment has an inconclusive answer; FDI seems to create a positive indirect impact on employment creation. However, research on the indirect effects of FDI on employment is very limited. Banga (2005) analyzed 78 three-digit industries in India have shown the impact of FDI, trade and technological advances on wages and employment. This study finding show that higher levels of FDI in the industry lead to higher wage rates in the industry; it has no impact on his employment. Likewise, technological advances are found to be labor savings.

Henneberger and Ziegler (2006) stated that the effect of FDI on the service sector is positive. Their study divided FDI into FDI search resources, FDI search efficiency, and FDI search market and they also analyzed FDI effects on employment by comparing the cost of international mobility of manufacturers and FDI users. They conclude that if the user is inactive or has high mobility costs, then the FDI market search will dominate and have a neutral or positive effect on the domestic labor market. If user mobility costs are low, then FDI seeking resources and efficiencies will dominate, with negatively related impacts on the domestic labor market.

In terms of indirect effects, Sjöholm (2008) studied the relationship between FDI and technology and found a clear relationship between employment and technology in China. On the one hand, new technology can make companies more competitive that allows them to grow and employ more labors. On the other hand, new technologies can also reduce labor demand by substituting low-skilled employees with fewer high-skilled employees. Therefore, changes in technology policy will affect employment creation. In addition, strong ownership is also an important part of employment creation.

Rizvi and Nishat (2009) examined the effect of FDI inflows on employment rates in India, Pakistan and China from 1985 to 2008. Using employment, FDI, and gross domestic product, this model found that FDI had no impact on employment creation in three countries.

Timipere, Krokeme, & Markjackson (2018) conducted a study to examine the impact of foreign direct investment on the unemployment rate in Nigeria from 1980 to 2015. The study shows that: There is a negative and insignificant relationship between foreign direct investment and the unemployment rate in Nigeria.

Djambaska and Lozanoska (2015) analyzed the relationship between unemployment and foreign direct investment (FDI) in the Republic of Macedonia. The results it is concluded that FDI did not have a statistically significant impact on the decrease of unemployment.

Based on the findings and discussions above, it is clear that FDI can have a positive effect on unemployment in some recipient countries and in some cases FDI does not play an important role to decrease unemployment. The results are somewhat diverse. Thus, the relationship between employment and FDI remains controversial.

Finally, we can conclude that the quantification of the overall impact of FDI on unemployment remains uncertain from a theoretical and empirical point of view. As long as FDI contributes to economic growth then it can contribute indirectly to decrease unemployment.

4. OBJECTIVES

The main goal of this paper is to analyze the long-run and short-run causal relations between the inflows of foreign direct investments (net inflows) and the unemployment rate for Indonesia. The findings of this paper might be of interest for the policymakers when reshaping their existing policies or when designing

new policies with the purpose of attracting new capital in Indonesia's economies under the form of foreign direct investments. In another fashion, the results of this study can be used when assessing the results and the benefits (brought to the local economy by foreign direct investments) of the existing policies in this particular field.

5. DATA AND METHODOLOGY

5.1. DATA

This study uses the secondary data from the World Bank publication and the central bureau of statistics of Indonesia. More specifically, the study uses the time-series data from 1991 to 2017.

5.2. MODEL

The dependent variable is unemployment rate and the independent variable is FDI of Indonesia. For estimation, the following equation is used:

$$UR = \beta_0 + \beta_1 FDI + u_t$$

where:

UR = Unemployment Rate

FDI = Foreign Direct Investment and,

u_t = error term

Unemployment Rate (UR) is defined as the percentage of labor force which is unemployed. For the present study, UR is measured in percent of labor force. FDI can be defined as total amount of foreign inflow to a country divide on GDP.

5.3. METHODOLOGY

5.3.1. UNIT ROOT TEST

To test the stationarity of time series data is crucial since such data sets are usually non-stationary and conducive to spurious regression. The non-stationary data affects the legitimacy of the standard statistical tests. Therefore, checking the stationarity of the variables is a prerequisite for applying any statistical method of estimation. Various solutions are proposed to deal with non-stationary time series; these include differencing of the series to reach stationarity. For the present study has used Augmented Dickey Fuller (ADF) test of stationary.

5.3.2. COINTEGRATION TEST

Before conduct co-integration test, an optimal lag length is selected to guarantee that the error term is normally distributed and does not have problems of heteroskedasticity and autocorrelation (Johannsen, 1995).

Johansen and Juselius (1990) co-integration test is applied to check the presence of stable long-run relation among the variables. Johansen's methodology is based on Vector Autoregressive (VAR) model of order m given by:

$$Y_t = \alpha + \sum_k^m \Pi_k Y_{t-k} + \varepsilon_t$$

Alternative from:

$$Y_t = \alpha + A_1 Y_{t-1} + \dots + A_m Y_{t-m} + \varepsilon_t$$

where, Y_t is a vector of the variables used in the study. The present study has used two variables (UR and FDI) so that Y_t is the vector of these two variables. α is represent vector of intercepts, Π_k is a time invariant 2*2 matrix and ε_t is a white noise vector of residuals.

In the first difference form, the above VAR model can be rewritten as:

$$\Delta Y_t = \alpha + \sum_{k=1}^{m-1} \Gamma_k \Delta Y_{t-k} + \Pi Y_{t-1} \varepsilon_t$$

where: $\Pi = \sum_{i=1}^m A_i - I$ and $\Gamma_i = -\sum_{j=i+1}^m A_j$

and Y_t and ε_t are already defined above and k is a lag length. Π is a 2*2 impact matrix because the present study uses two variables. Π gives information on the long-run relation among the variables and its rank represents the number of cointegrating relationships. In this regard, Trace test statistic and Maximum Eigenvalue statistic have been used to check the number of co-integrating vectors (Johansen,1995).

5.3.3. VECTOR ERROR CORRECTION MODEL (VECM)

In order to identify the long-run relationship among the series under study, the Johansen co-integration test must be done. If there is co-movement among the variables of interest and a possibility that these variables will trend together to form stable long run, we may estimate the VECM. VECM is used to analyze the dynamics of the equilibrium both in the short and the long-run. VECM for the present study is as follows:

$$\Delta UR_t = \beta_{1,t} + \sum_{m=1}^{n-1} \beta_{11,j} \Delta UR_{t-j} + \sum_{m=1}^{n-1} \beta_{12,j} \Delta FDI_{t-j} + \delta_1 EC_{t-1} + \varepsilon_{1t} \quad (1)$$

$$\Delta FDI_t = \beta_{2,t} + \sum_{m=1}^{n-1} \beta_{21,j} \Delta FDI_{t-j} + \sum_{m=1}^{n-1} \beta_{22,j} \Delta UR_{t-j} + \delta_2 EC_{t-1} + \varepsilon_{2t} \quad (2)$$

UR and FDI denote Unemployment rate and Foreign Direct Investment. The coefficients of the EC_{t-1} term indicate causality in the long run and the joint F test of the coefficients of the first differenced independent variables confirms short-run causality. Δ denotes first-difference operator. ε_{1t} and ε_{2t} are the stationary disturbance terms for Equation (1) and (2), respectively. N is the order of the VAR, which is translated into lag of n-1 in the error correction mechanism. δ_1 and δ_2 denote the coefficients of long run Granger causality for equations.

5.3.4. DIAGNOSTIC TEST

The standard VECM based diagnostic tests have been applied to determine the validity of the estimated model. Vector Error Correction residual-based Lagrangian Multiplier (LM) is tested for serial correlation. VEC residual based White Test for heteroskedasticity and VEC residual based normality test are applied in this regard

6. RESULT FINDINGS AND DISCUSSION

6.1. UNIT ROOT TEST RESULT

In this section, the result findings for the stationary test, the Johansen cointegration test and the vector error correction mechanism model are presented. Table 1 shows the result of standard Augmented Dickey-Fuller (ADF).

TABLE 1: UNIT ROOT TEST BY AUGMENTED DICKEY-FULLER TEST

Variables	Intercept (Probability)		Intercept and Trend (Probability)	
	Level	First Difference	Level	First Difference
UR	0.1983	0.0398**	0.9300	0.0226**
FDI	0.2944	0.0294**	0.1991	0.0715*

*Denotes rejection of the null hypothesis at 1 percent level of significant

**Denotes rejection of the null hypothesis at the 5 percent level of significance

***Denotes rejection of the null hypothesis at the 10 percent level of significance

The test result show that all the variables are found to be nonstationary at level, I(0). After first differencing, the null hypothesis (H0) for the existence of unit root in each variables is rejected, implying that the variables used in the study are integrated at order one, I(1). The findings confirm that the Johansen cointegration

mechanism is an appropriate technique used to check whether the variables are cointegrated. The findings confirm that the Johansen cointegration mechanism is an appropriate technique used to check whether the variables are cointegrated.

6.2. SELECTION MAXIMUM LAG LENGTH

Before implement the Johansen cointegration test, the first thing to do is to decide the optimal lag length for the VEC mechanism. In this study, the number of lag chosen is based on the maximum value of AIC. The result of lag length shows at Table. 2

TABLE 2: OPTIMAL LAG LENGTH

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-80.37423	NA	4.425274	7.162977	7.261715	7.187809
1	-50.59633	51.78765	0.471732	4.921420	5.217636	4.995918
2	-44.53237	9.491417	0.398635	4.741945	5.235638	4.866108
3	-39.13009	7.516214	0.362069	4.620008	5.311178	4.793835
4	-26.11853	15.84016*	0.173562*	3.836394*	4.725042*	4.059887*

According the table above, optimal lag at VAR model is 4. To test existence of cointegration the lag length lag use is 3.

6.3 COINTEGRATION TEST RESULT

Table 3 presents the results of the bivariate Johansen co-integration tests. The empirical results of Johansen cointegration test shows that there is cointegration between the variables in the model as evidenced by the trace statistic of 34.61011, which is greater than the critical value of 20.26184 (probability value 0.0003) at 5% level of significance (Table 3). This result also confirm by maximum eigenvalue statistic value is 31.03657, which is greater than the critical value of 15.89210 (probability value 0.0001) at 5 % level of significance. That is to say, the variables have a long run cointegrating relationship.

TABLE 3: RESULTS OF JOHANSEN COINTEGRATION TEST

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	Critical Value 0.05	Prob.**	Max-Eigen Statistic	Critical Value 0.05	Prob.**
None *	0.740608	34.61011	20.26184	0.0003	31.03657	15.89210	0.0001
At most 1	0.143903	3.573542	9.164546	0.4793	3.573542	9.164546	0.4793

6.4 VECTOR ERROR CORRECTION MODEL (VECM)

As a long run relationship has been established, the present study using Vector Error Correction Mechanism (VECM). The result findings of VECM estimation show in the following table 4.

TABLE 4: LONG-RUN TEST RESULT

Dependent Variable = UR			
Variable	Coefficient	S.E	t-values
Constant	-7.219394	0.33415	-21.605
FDI	1.418441	0.21977	6.45431

The result can be represented in the form of an equation as follows:

$$UR_t = -7.22 + 1.42FDI_t + u_t$$

The focus of this study is to examine the response of unemployment to FDI; therefore, cointegrating vector is normalized by unemployment rate. From table above, the result indicates that FDI is significantly related to unemployment level in Indonesia. The results show that FDI does influence a surge in unemployment rate in the long run. The 1 % increase in the flow of FDI will lead to 1.42 % decrease in unemployment rate. This result satisfies the priory expectation.

TABLE 5: SHORT RUN TEST RESULT

Section A		
Variables	Equation	Equation
	ΔUR	ΔFDI
Constant	-0.029874 (0.07282) [-0.41023]	0.027835 (0.19580) [0.14216]
D(UR(-1))	0.228730 (0.19209) [1.19072]	-1.624346 (0.51649) [-3.14499]
D(UR(-2))	0.108089 (0.20480) [0.52777]	0.359940 (0.55066) [0.65365]
D(UR(-3))	0.139249 (0.16732) [0.83223]	0.460617 (0.44988) [1.02387]
D(FDI(-1))	0.107251 (0.09215) [1.16387]	0.722533 (0.24777) [2.91619]
D(FDI(-2))	0.294235 (0.08520) [3.45366]	-0.015105 (0.22907) [-0.06594]
D(FDI(-3))	0.264825 (0.10038) [2.63827]	0.744215 (0.26989) [2.75748]
EC(t-1)	-0.211333 (0.05025) [-4.20582]	-0.468227 (0.13510) [-3.46572]
SECTION B		
R-squared	0.727328	0.601670
Adj. R-squared	0.600081	0.415783
F-statistic	5.715882	3.236751

Table 5 above shows that long rung coefficient EC(t-1) of the UR equation is negative and significantly at 5 % level (p-value<0.05). In the short run, lagged FDI has positive and significantly short-term relationship at lag 2 and lag 3 with unemployment. This implies that both of long run and short run, there are causal link

between Unemployment and FDI. The findings suggest the important role of FDI in stimulating Unemployment rate in Indonesia. The findings of this paper are consistent with a number of empirical studies of He (2018), Shari et al (2012), Stamatiou and Dritsakis (2014) and others. However, some empirical study are inconsistent with this paper (Timipere, Krokeme, & Markjackson (2018) and Djambaska and Lozanoska (2015). It can be concluded that the findings on the causal impact of FDI on unemployment are still controversial.

6.5 DIAGNOSTIC TEST RESULT

In this paper conducted diagnostic tests to check the problem of autocorrelation, heteroscedasticity and normality. The present results in Table 6 show that there are no problem of autocorrelation and heteroskedasticity ($p > 0.05$). Findings also confirm the model to be a normality distributed.

TABLE 6: DIAGNOSTIC STATISTIC TEST

Test Statistics	Prob.	Conclusion
LM Test	0.2983 (lag 1) 0.3382 (lag 2) 0.4365 (lag 3)	No autocorrelation
Breusch Pagan Godfrey	0.9892	No Heteroskedasticity
Jarque-Bera	0.2337	Normality Distributed

The finding of diagnostic test results is satisfactory. These satisfactory results indicate the validity of the estimates.

7. CONCLUSION

The study has examined the causality of Foreign Direct Investment on Unemployment in Indonesia. The result suggests that FDI has a positive and significant long-run relationship with unemployment. In this regard, FDI can prove to be a tool for stimulating to reduce unemployment.

These findings also suggest that there is a causality relation running from foreign direct investment towards unemployment. Therefore, the government of Indonesia should be bear in mind all aspects related to the FDI domain when they intend to design policies with the purpose of reducing the unemployment.

However, the results of this study did not entirely support the hypothesis on a clear positive impact of FDI on unemployment. Also, the time series data used in this study is a short time series, which is a limitation in this study. Therefore, we believe that the results displayed in this research paper should be regarded with great caution and they should be treated more as starting points for more elaborate future research. Thus, these results should be further validated through different methods and maybe with the help of quarterly data.

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