ABSTRACT

This thesis aims to investigate the behavior of foreign direct investment (FDI) and domestic investment in Indonesia which is expected to be explained by several explanatory variables including regional wage setting, inflation, as well as regional domestic product. More specifically, this thesis focuses on the effect of an annual increase of minimum regional wage setting on investment. This focus is crucial as the minimum regional wage setting has been perceived as a sensitive issue for investors.

Using 33 provincial level data within a period of 2004 – 2012, this thesis employs a dynamic panel data that enables to see the behavior of investment in the short run and long run. The result shows that an increase in the regional wage setting reduces both FDI and domestic investment in the short run. This confirms the conjecture of the effect of minimum regional wage setting on investment. However, in the long run, an increase in the minimum regional wage setting tends to increase both FDI and domestic investment. This indicates that in the long run, an increase in the regional wage setting is expected to correspond to the higher labor productivity.

Inflation has a mixture of outcome on investment. In the short run, inflation has positive effect on both FDI and domestic investment. In the long run inflation has positive effect on FDI, but negative effect on domestic investment. The result indicates that investors tend to see an increase in prices as a basis to increase production in the short run. However in the long run, higher inflation rate is seen as higher risk by domestic investors, so that it reduces investment.

As it is expected, domestic regional output has positive effect on FDI and domestic investment both in the short run and long run. This indicates that investment progresses along with the improvement of the capacity of economy.

Keywords: Minimum Regional wage setting, foreign direct investment and domestic investment, dynamic panel data.