Offshoring, Firm-Level Adjustment and Labor Market Outcomes*

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Abstract

This paper contributes to the China shock debate. It studies the dynamic effects of offshoring on the unemployment rates and wage inequality across the high-skilled and low-skilled workers through the dynamics of firms' production location and entry decisions in general equilibrium. First, I examine the dynamic effects of offshoring cost reduction due to China's trade liberalization. Estimates from vector autoregressions (VARs) show that a decrease in offshoring costs is associated with a short-lived increase in low-skilled unemployment, but a persistent decline in high-skilled unemployment and a less persistent expansion of wage gap in the source country. Second, I build a two-country trade-in-task model with firm heterogeneity, endogenous selection into entry and offshoring as well as search and matching fricsions to study the channels through which offshoring cost reductions affect the labor market outcomes for different skill groups over time. The model successfully reproduces the VAR evidence and highlights the importance of endogenous firm entry and labor market frictions in generating the empirical dynamic responses of wage and unemployment across different skill groups.

JEL codes: F16, F23, J24, J31, J64, F41, F66

Keywords: China shock; Comparative Advantage; Macroeconomic dynamics; Labor market; Unemployment; Wage Inequality

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