

## Helpdesk Research Report: Indonesian Financial Crisis (1997-1998)

Date: 30.03.09

**Query:** Please identify literature on the social impacts of the financial crisis in Indonesia (1997-1998) with particular attention to the causes of social unrest (including unemployment). Please include information on the policy responses implemented.

**Enquirer:** Development Research Center of the State Council of China, and DFID China.

### Contents

1. Overview
2. Social unrest and conflict
3. Other social impacts
4. Authors and contributors

### 1. Overview

In the 1980s and early 1990s, Indonesia along with other Asian countries experienced strong economic growth which produced reductions in poverty and improvements in social indicators. The financial crisis of 1997 undid many of these improvements as GDP dropped, unemployment rose, wages eroded, and prices increased dramatically. The rapid descent into economic hardship strained already-present tensions in society and contributed to increased criminality. President Suharto's government<sup>1</sup> lost its legitimacy and control, and in 1998 the President stepped down amid widespread social unrest.

Although the financial crisis was the catalyst that triggered the fall of the Suharto government, it was not the underlying cause. Social conflicts, divisions along regional, class, and cultural lines, corruption, and criminal gangs were deeply rooted in Indonesian society. While overt violent conflict had been mostly suppressed under the Suharto regime, the underlying tensions remained. The financial crisis weakened state institutions and brought the situation to the breaking point, allowing repressed tensions to flare up. A far-reaching governance and economic transition ensued.

During the crisis, social safety net programmes were implemented to improve food security, stimulate the economy, and provide basic health and education services. There were serious doubts, however, both internationally and within Indonesia, about the programmes' effectiveness and targeting, and about the potential for corruption.

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<sup>1</sup> Suharto's regime was known as the 'New Order' throughout its 32-year rule, a term chosen to mark its opposition to the 'old order' represented by his predecessor, Sukarno.

## 2. Social unrest and conflict

**Malley, M., 2001, 'Class, Region, and Culture: The Sources of Social Conflict in Indonesia', in *Social Cohesion and Conflict Prevention in Asia: Managing Diversity Through Development*, World Bank**

Malley argues that the upsurge in social conflict in Indonesia in the late 1990s 'stems from the weakening of the economic and political forces that had underpinned rapid economic growth and enforced social stability.' The country is characterised by long-standing divisions along regional lines (including regional separatist movements both peaceful and armed, and less-radical demands for greater regional autonomy), class lines (characterised by labour unrest and disputes over land rights), and cultural identities (particularly between ethnic Chinese and indigenous Indonesians, and among the various groups of indigenous Indonesians themselves).

Under the Suharto regime, government policies 'tended to exacerbate social cleavages' but 'coercive bureaucratic and military measures' were used 'to prevent social tensions created by official economic policies from developing into open, violent conflicts and to subdue them when they did.' Following the fall of the Suharto regime, the suppressed tensions erupted into violent conflict in many areas. This document recommends that new policies aimed at resolving the underlying tensions, rather than suppressing them, should be pursued. This includes the need to 'replace the institutions that underpin the inequitable distribution of resources among social groups divided by region, class, and culture.'

**Kristiansen, S., 2003. 'Violent Youth Groups in Indonesia: The Cases of Yogyakarta and Nusa Tenggara Barat', *SOJOURN: Journal of Social Issues in Southeast Asia*, vol. 18, no. 1**

Gangsters and racketeers have operated in Indonesia for many years, often with the consent of, and under the informal control of, the police and military. However, 'problems of violent youth groups have escalated in Indonesia, following economic recession, unemployment, and weakened state institutions. Young people have been hit by the lack of income and broken expectations. In consequence, youth groups emerge and arrange for members' economic revenue as well as identity creation and confidence.' (p. 110) There has been an increase in 'violence... related to problems of economic crisis and unemployment, combined with the weakening of central state institutions, including the police.' (p. 111)

Kristiansen argues that 'a main challenge under the present conditions in Indonesia is developing new institutions and transparent government procedures that can fill the power vacuum after the fall of the authoritarian system.... Instead of balancing violent youth movements with state terror to regain the monopoly of force, more should be done to minimize the reasons for hostility.' (p. 133-134)

**Tadjoeddin, M. Z. and Murshed, S. M., 2007, 'Socio-Economic Determinants of Everyday Violence in Indonesia: An Empirical Investigation of Javanese Districts, 1994-2003', *Journal of Peace Research*, no. 44. <http://jpr.sagepub.com/cgi/reprint/44/6/689>**

Following Indonesia's deep economic crisis, the country undertook three major transitions: from an autocratic system of politics and governance to a democratic one, from a 'patron-client and crony capitalist economic system to a rules-based market economy' (p. 692), and from a 'centralized socio-political and economic system to a decentralized one.' (p. 692) The crisis was marked by an eruption of violent conflict in 1997 which peaked in 1999. The distribution of and nature of conflict, however, varied greatly across the country.

The authors find that 'economic crises, which are measured by the size of economic contraction and the increase in poverty, are positively associated with the level of violence.' (p. 689) 'Economic insecurity potentially results in feelings of vulnerability and frustration within society, which in turn could easily turn violent. Such human insecurity significantly lowers the opportunity cost of engaging in violence. Therefore, policies aimed at reducing socio-economic human insecurity simultaneously lower violence.... most of the determinants of violence we have investigated are closely related to indicators targeted in the Millennium Development Goals (MDGs), notably halving poverty and achieving

universal education.’ (p. 706) However, the authors also note that ‘deep social divisions within Indonesian society have been an inseparable part of the crisis and transition itself.’ (p. 689)

**Wee, V., 2002, ‘Social Fragmentation in Indonesia: A Crisis from Suharto’s New Order’, Working paper no. 31, Southeast Asia Research Centre, City University of Hong Kong.**  
[http://www.cityu.edu.hk/searc/WP31\\_02\\_Wee.pdf](http://www.cityu.edu.hk/searc/WP31_02_Wee.pdf)

Indonesia was hard hit by the financial crisis. People’s livelihoods were endangered by the fall in economic activity (e.g. a quarter of all SMEs shut down by 1998) and rising prices (e.g. the price of rice tripled in only six months). As a result, political stability disappeared and the government lost all legitimacy. This catalysed social fragmentation leading to ‘massive social unrest, riots, ethnic conflicts, separatist movements, as well as crime and interpersonal violence.’ (p. 2)

However, the author notes that this fragmentation was ‘deeply rooted in the institutional dysfunctionality brought about by Suharto’s ‘New Order’. (p. 2) Even before the crisis, social fragmentation was already present but had been papered over by an authoritarian government that did not permit the expression of political difference... the Asian financial crisis merely sparked off the eruption of long smouldering discontent.’ Under the Suharto regime, state capture, a form of large-scale systemic corruption, weakened state institutions and contributed to social fragmentation, widespread cynicism and distrust of state institutions. It also subverted efforts to promote social and economic development.

Wee concludes that ‘corruption in post-Suharto Indonesia continues unabated’ (p. 13), state capture remains ‘the primary mode of governance in Indonesia’ (p. 19), and democratisation alone cannot effect change without ‘economic redistribution, the eradication of corruption and institutional reform.’ (p. 19)

**Barron, P., Kaiser, K., and Pradhan, M., 2004, ‘Local Conflict in Indonesia: Measuring Incidence and Identifying Patterns’, World Bank Policy Research Working Paper no. 3384, World Bank.**  
<http://go.worldbank.org/X6XRKZJ8M0>

This paper aims to identify factors that contributed to the violent unrest that swept Indonesia in 1998. Suharto’s authoritarian regime ‘managed conflict through repression with state structures regulated and vertical in nature, and the army, through its presence in each and every Indonesian village, quelling any latent unrest.’ (p. 2-3) The authors find that poverty *per se* is not correlated with conflict, and were surprised to note that horizontal inequality is associated with lower levels of conflict. Changes in economic circumstances are linked with increased conflict, and unemployment is ‘universally closely associated with higher conflict rates.’ (p. 31) Other factors correlated with conflict include:

- high migration for work/school,
- the share of converted land in rural areas,
- natural disasters,
- areas where there is no single ethnic group dominant, and
- clustering of ethnic groups within villages across a sub-district.

**Murshed, S. M., and Tadjoeidin, M. Z., 2008, ‘Is Fiscal Decentralization Conflict Abating? Routine Violence and District Level Government in Java, Indonesia’, Microcon Research Working Paper 7.** [http://www.microconflict.eu/publications/RWP7\\_MM\\_ZT.pdf](http://www.microconflict.eu/publications/RWP7_MM_ZT.pdf)

Following the economic crisis and the fall of the Suharto government, a programme of fiscal decentralisation was undertaken as part of the country’s democratic transition. This policy directly aimed to give more power to regional authorities and ‘mollify the few, but high profile, separatist tendencies in the country.’ (p. 2) Murshed and Tadjoeidin find that social violence in Java ‘is negatively associated with the impact of fiscal decentralization and the size of local government.’ (p. 28) However, fiscal decentralization has also led to widening disparities among local regions, so while ‘greater local government spending can lead to conflict abatement... this capacity is greater in richer districts.’ (p. 29) This suggests the importance of a central transfer mechanism.

## 2. Other social impacts

**Knowles, J. C., Pernia, E. M., and Racelis, M., 1999, 'Social Consequences of the Financial Crisis in Asia', Economic Staff Paper Number 60, Asian Development Bank.**

[http://www.adb.org/Documents/EDRC/Staff\\_Papers/ESP060.pdf](http://www.adb.org/Documents/EDRC/Staff_Papers/ESP060.pdf)

This paper reviews the social impacts of the Asian financial crisis in Indonesia and five other countries. It traces the mechanisms by which the structural crisis in banking and corporate finance produced social impacts: dramatic price inflation, particularly for goods with high import contents such as pharmaceuticals, food, and fuel; a drop in the demand for labour resulting in unemployment and reduced wages; losses of savings; constricted access to credit; and reductions in government budgets (barring the ability to run large deficits). These produced significant impacts on inequality, poverty, education, and health (including family planning and reproductive health). The poor, women, youth, and the elderly were most strongly affected, as were workers in manufacturing and construction, although declining wages affected workers in all sectors. Urban populations were hit harder than rural areas. Ethnic and religious minorities were targeted as scapegoats.

The crisis also weakened community cooperation and participation in Indonesia (although in other countries, such as Thailand and Korea, community ties appear to have been strengthened). The fast-growing numbers of needy people overwhelmed the relatively weak community institutions available to support them and historical institutions of reciprocal labour, food-sharing, community savings, neighbourhood security watches, and volunteering for other community activities declined or were abolished. Participation in religious activities also suffered. Crime rates increased, including looting and robbery, including extreme violence even in combination with petty theft.

**UNESCAP, 1999, 'Social impact of the Economic Crisis', Economic and Social Survey of Asia and the Pacific 1999', United Nations Economic and Social Commission for Asia and the Pacific.**

<http://www.unescap.org/drpad/publication/survey1999/svy99ch3.pdf>

This paper presents a very useful framework for understanding the mechanisms by which economic impacts are translated into social impacts (see p. 117). Prior to the economic crisis, Indonesia and other Asian countries experienced rapid economic growth, and rising per capita income (more than doubling in Indonesia from the mid-1980s to the mid-1990s) had produced broad improvements in health and education. The crisis produced a dramatic increase in unemployment and a decline in wages for those who did not lose their jobs, with women being particularly vulnerable. Declines in income and dramatic increases in the price of drugs resulted in a decline in the use of health services, and rising food prices resulted in increasing incidences of malnutrition. Declining income also reduced access to education, especially to higher-quality education. Approximately 25% of children and youth who should have been in school dropped out, and girls' education was considered a lower priority than that of boys. A major social safety net programme was initiated to overcome the immediate adverse effects of the economic crisis, focusing on improving food security, creating employment, developing small and medium-sized enterprises, and providing basic services, particularly in health and education.

**Sumarto, S., Wetterberg, A. and Pritchett, L., 1998, 'The Social Impact of the Crisis in Indonesia: Results from a Nationwide Kecamatan Survey', SMERU Research Institute.**

<http://www.smeru.or.id/report/workpaper/crisimpactkecsurv/kecsur1.pdf>

This national survey shows that urban areas were harder hit by the crisis than rural areas, and that the impacts were very uneven: some regions have experienced great difficulties and others have done relatively well. Further, there was little connection between initial poverty levels and the extent to which an area was hit by the crisis. The impact on food security, employment, and education has been worst in urban areas. Impacts on health have been more evenly distributed.

**Macfarlane Burnet Centre for Medical Research, 2000, 'The Impact of the Asian Financial Crisis on the Health Sector in Indonesia', Macfarlane Burnet Centre for Medical Research and AusAID. [http://www.usaid.gov.au/publications/pdf/health\\_indonesia.pdf](http://www.usaid.gov.au/publications/pdf/health_indonesia.pdf)**

This paper gives a detailed look at the impacts of the crisis on the health sector. It shows that the crisis resulted in a decline in both public and private expenditure on health. Use of both public sector and private sector health facilities declined, and prices of drugs increased dramatically (doubling for commonly-used antibiotics and chloroquine). The impacts are very uneven geographically but tended to be worst in urban areas. The number of people experiencing health problems increased substantially, with greater effects on women. There are concerns about micronutrient deficiencies among children.

The Indonesian government expanded and restructured the social safety net with assistance from donors, primarily the World Bank and ADB. Poor households received health cards with which they could obtain certain free health services. The report warns that health services are being reorganised into a more decentralised structure, and that confusion resulting from the reorganisation risks adversely affecting the smooth delivery of services.

**UNESCAP-DRPAD, 2002, 'Social Impact of the Asian Economic Crisis' in Protecting Marginalized Groups During Economic Downturns, Development Research and Policy Analysis Division (DRPAD), United Nations Economic and Social Commission for Asia and the Pacific. <http://www.unescap.org/drpad/publication/protecting%20marginalized%20groups/ch1.pdf>**

This paper gives an overview of social impacts of the financial crisis in several countries, including Indonesia. It argues that improvements in social indicators in the 1980s and early 1990s were a result of strong economic growth rather than social policy choices or public expenditure, and 'the impact of the economic crisis upon the real sector was drastic and harsh.' (p. 9) Unemployment, wage freezes, wage reductions, and rapid inflation led to 'massive erosion of real wages.' (p. 11) 'The reduction in income was responsible for the reversal of many of the past achievements in the areas of poverty alleviation, health care and education.' (p. 11)

**Booth, A., 1999, 'The Social Impact of the Asian Crisis: What Do We Know Two Years On?', *Asian-Pacific Economic Literature*, vol. 13, no. 2. <http://dx.doi.org/10.1111/1467-8411.00060>**

This paper summarises the social impacts of the crisis in Indonesia and other countries, critically examining poverty estimates produced during the crisis and reviewing the performance of the social security programmes implemented to combat it. Booth argues that many of the urban unemployed in Indonesia shifted to lower-paid informal work, and anticipates a problem of long-term underemployment. Education services were already experiencing declining public spending and declining enrolments, and these problems worsened during the crisis.

In response to the crisis, food-for-work programmes were developed, although there were concerns that such programmes failed to address the needs of women, the elderly, and the infirm, and that the programmes were vulnerable to corruption. 'By mid-1999 there was a widespread conviction among the donor community that most of the so-called social safety net programs in Indonesia had not been very successful... [and] these doubts were shared by many in the Indonesian bureaucracy.' (p. 26)

**Thee, K. W., 2002, 'The Indonesian Economic Crisis and the Long Road to Recovery', XIII International Economic History Congress, Buenos Aires, 22-26 July 2002. <http://eh.net/XIIICongress/Papers/Thee.pdf>**

This conference paper reviews impacts of and responses to the Indonesian economic crisis. The sharp decline in economic production, increased unemployment, and the rise in prices of many goods and services caused widespread socio-economic problems. Many unemployed workers sought informal work which increased competition and depressed wages. Absolute poverty increased and food security was a severe problem in some urban areas. Many low-income parents had to remove their children from school (especially secondary school; primary schools were not affected). Use of

health services declined. Social Safety Net (SSN) programmes were introduced as short-term emergency measures, including public works programmes, steps to preserve the availability of health and education services, and subsidies for basic foods, petroleum products, electricity and transport. 'However, due to inadequate targeting and maladministration, quite a sizable amount of SSN funds... were either misused, simply wasted or even corrupted.' (p. 34)

**Social Monitoring and Early Response Unit, 1999. 'Results of a SMERU Conference on Monitoring the Social Impact of the Crisis: Lessons Learned in 1999'.**

<http://www.smeru.or.id/report/workshop/socimpccrisis/confcris1.pdf>

This collection of presentations from a conference in December 1999 presents lessons learned from monitoring the implementation of social safety net programmes, as well as the impacts of the crisis on health and the differential employment impacts for men and women.

#### **4. Authors and Contributors**

##### **Author**

This research report was compiled by Brian Lucas ([brian@gsdrc.org](mailto:brian@gsdrc.org)).

##### **Contributors**

Mansoob Murshed, Professor, University of Birmingham

Stein Kristiansen, Professor, University of Agder

Heather Marquette, Lecturer, University of Birmingham

Simon DeLay, Lecturer, University of Birmingham

Paul Jackson, Head, School of Government and Society, University of Birmingham

Philip Amis, Head, International Development Department, University of Birmingham

Karen Johnson, Senior Consultant, Social Development Direct

Catherine Arnold, Social Development Adviser, Equity and Rights Team, DFID

John Holmwood, Professor, Department of Sociology, University of Birmingham

Richard Batley, Professor, International Development Department, University of Birmingham

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