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We had all better get used to growing unemployment — and fear for a lost generation

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Unemployment is the big political issue of 2009. The loss of more than a million jobs in the US in the final two months of 2008 is testimony to the savage shake-out following the financial market meltdown last autumn. Barack Obama's emergency package will be sold as all that stands between America and the return of the Great Depression.

In the UK, the labour market has deteriorated for the past year, but the outlook has become far bleaker over the past few months. Gordon Brown's jobs summit in Downing Street is all about ensuring that those thrown out of work in the coming months do not become part of a lost army of the long-term unemployed. There is, in all honesty, a limit to what policymakers can do and they know it. Unemployment is bound to rise in the US, stimulus package or not. Brown can hold a jobs summit every other day until Easter, but the daily drip feed of redundancies will continue relentlessly.

Even so, active labour market policies are still worth the effort. The lesson of the 1980s is that when people lose touch with the labour market altogether, the loss of skills and motivation has dire personal and social consequences. Ministers are particularly worried about the rise in unemployment in the under-24 age group, because there is evidence that a spell on the dole when you are young leaves the deepest scars.

Brown also believes an interventionist strategy would have a beneficial impact on the wider economy, because the fear of being made unemployed is affecting consumer confidence and spending. For now, the government is sticking to its forecast of a savage but short recession, but that will not come to pass if there are negative-feedback effects from rapidly rising unemployment back into the housing market, where prices are falling at an annual rate of 25-30%. As things stand, it is hard to envisage the economy bottoming out in the summer, as Alistair Darling predicted in the pre-budget report, but the feeling in Whitehall is that the economy may still show unexpected resilience this year - provided there is a comprehensive package for jobs, housing and banking that dovetails with the boost to growth from macro-economic policy.

Stimulus

Mindful not to be as dilatory as their predecessors in the 1930s, policymakers have slashed interest rates and allowed public borrowing to soar. They have bailed out the banks and are now planning to flood the financial system with money. Oil prices have collapsed and tumbling inflation means that real incomes for those in work are rising. The increase in public-sector employment since the 1930s provides a large chunk of the workforce with some protection against the downturn. All of this amounts to a powerful stimulus. Were Obama's fiscal package - or even the prospect of it - to brighten the mood, economic recovery could conceivably begin in the autumn.

Equally, ministers know that 2009 could be even more of a stinker than expected. Despite the supposed boost from a weaker pound, UK factory output fell 2.9% in November alone and, in a sign of the neglect of manufacturing in the past decade, is lower than when Labour came to power in 1997.

But the final quarter of 2008 was marked not just by the severity of the UK retrenchment but by its widespread nature. What started as a misadventure in the Anglo-Saxon economies (with Spain and Ireland thrown in) has spread to Asia and continental Europe. Given the exposure to US consumer spending, it always appeared fanciful that China, Japan and South Korea would be able to de-couple themselves from the west and so it has proved.

Industrial production in Japan was down 16.2% in the year to November; factory output fell at an annual rate of 14.1% in South Korea. China's annual industrial growth slowed from 12.8% in August to 5.4% in November. These are all economies highly dependent on exports for growth, although Beijing is trying to shift resources to infrastructure and consumer spending.

Germany also relies on exports. It is the world's main source of capital goods and has done well out of the rapid industrialisation of the emerging Asian economies over the past decade. But with investment collapsing, Germany is struggling; industrial orders fell by 6% in November after a 6.3% drop in October. Other European nations are also suffering: Swedish industrial production fell by 11.9% in the year to November, while Spain's was down more than 15%.

If the growing problems of the top Asian and European economies are set to be one theme in 2009, another will be the emerging economies' vulnerability to a shortage of capital caused by western countries pressuring their banks to make a priority of key domestic constituencies, such as homeowners and small businesses. Emerging market economies have relied heavily on flows of investment from abroad; now the taps are likely to be turned off as the G7 seeks to finance burgeoning budget deficits. These conditions are quite similar to those in the early 1980s that spawned the Latin American debt crisis.

The country that will be responsible for most of this "crowding out" of emerging markets will be the US, which according to estimates will have to find buyers for $6.3tn (£4.1tn) of government debt this year (a mix of $4.3tn of debt rolled over and $2tn of new financing).

As Alex Jurshevski of Recovery Partners notes, the textbook response for policymakers looking to attract foreign funding in the wake of a banking crisis is to raise interest rates and clean up the financial system by allowing weak institutions to fail or forcibly merging them. "The Fed and other central banks globally have done pretty much the exact opposite of this - they have cut interest rates and propped up most of the zombies. Foreign investors [governments and institutions] are now being asked to finance yawning US deficits at zero or negative real yields."

Mug's game

Until recently, the US offered a bargain to China and other Asian creditors: we will buy your cheap exports and run up colossal trade deficits and in return you buy up our treasury bills and let us keep living beyond our means. The US has now, inevitably, had to renege on its half of the deal and a third key theme of 2009 will be whether foreign investors are prepared to keep buying US government debt and at what price. The risks of a crisis in the bond market and a collapse in the US dollar are considerable.

Finally, there's the potential impact on an already enfeebled banking system of rapidly rising unemployment and a wave of corporate collapses in 2009. The reason policymakers have embarked on a wave of frenetic activism is because forecasting is a mug's game in the current economic environment. Nobody really has the first idea whether 2009 will see economic recovery, a return to the 1930s or something in between. In the circumstances, policymakers would rather be criticised for doing too much rather than too little. Such caution is amply justified.