



# Global Highlights

June 13<sup>th</sup> 2008

## Innovation

Galo Nuño Barrau  
BBVA Global Trends Unit  
[galo.nuno@grupobbva.com](mailto:galo.nuno@grupobbva.com)

### Prediction Markets as Forecasting Tools: From Google to the U.S. Elections

➤ Do you have a hunch about who will be the next U.S. president? Do you want to bet on it? It is very easy, go to the [Wall Street Journal Political Market website](#) and play. The **WSJ** Political Market is an exchange marketplace where traded “stocks” are political or economic outcomes and the currency is imaginary. There you can trade on political issues such as the next President or on economic ones, such as the U.S. going into recession or the Fed Funds rate being lower than 1% at the end of 2008.

➤ This is an example of a **prediction market**. Prediction markets are small-scale electronic markets where participants trade contracts whose payoffs are tied to measurable future events, thereby yielding prices that can be interpreted as market-aggregated forecast.<sup>1</sup> Their proponents say that these markets rapidly aggregate information dispersed across an organization or the society to produce “collective wisdom” forecasts that are at least as accurate as expert opinions.

➤ They are beginning to be employed to analyze all kind of events, from terrorist attacks to flu epidemics. Furthermore, one of their most interesting uses is to help improve business decisions, as they constitute an effective way to let information flow upward inside an organization. Some executives consider that valuable information (such as the clients feeling about a new product) lies scattered around the organization but don't know how to retrieve it. Predictions markets allow them to get a better picture of what people know and can't (or don't want to) tell.

➤ **Google** is maybe the most famous company with a prediction market where employees may bet on the performance of new products or the evolution of Google's share price. Managers use the results as valuable forecast information and as a feedback to improve their products. More companies are joining the club and the usefulness of a prediction market for every company has been discussed by the consultancy firm **Mckinsey & Co.** in a recent [report](#).

➤ However crowds may be wrong, too. As a recent article in the technology journal [Wired](#) highlights, prediction markets have failed in some of the main episodes in the Democrat primaries between Senators Obama and Clinton. Economist **Paul Krugman** even wrote a New York Times Op-Ed titled “[Nobody Knows Anything](#)” stating that markets may easily fail in their forecasts about the future (As the saying goes: “A thousand fools do not make a genius”).

➤ Notwithstanding, prediction markets can be improved to become more functional. For example, playing with real money helps people to seriously ponder their decisions. Clear questions, short-term evaluations and a deep pool of traders are other conditions to make these markets more efficient. Expert advice will be always necessary, however as Abraham Lincoln stated: “You can fool [...] all of the people some of the time, but you can not fool all of the people all of the time.” The wisdom of crowds can be useful.

---

<sup>1</sup> An introduction to Predictive Markets can be found in [Wolfers and Zitzewitz “Prediction Markets in Theory and Practice”](#). NBER Working Paper No. 12083. March 2006.