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A Safe Bet

By Reuven Brenner A8

So much for shorting Osama bin Laden. This week, after a Congressional backlash, the Pentagon detonated its plan to launch a futures-trading market to price the risk of terrorist attacks. When word of the "terror market" idea got out, the political calculus drained support from what critics called an absurd, even offensive, idea. That's a shame: Done right, it might have been an indispensable tool.

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The Pentagon plan did have flaws. Democrats and Republicans weren't wrong in their objections to government support for the effort—there is no reason for government to fund this or any other futures market.

But the benefit for society isn't that some parties would profit from trading in such markets, but that such markets would price risks visibly and more efficiently than they do today. The effect would be not only a better allocation of capital but valuable culling of information that is difficult to assemble otherwise.

Risks of terror, of confiscation of property, of chances of war and peace are priced already today—only less transparently. Owners of real estate in New York pay more insurance to account for higher risk of terror. High-rises pay more insurance than low-rises. Stock markets price the consequences of war, terror and peace, too. In the month following March 17—the day President Bush gave his ultimatum to Saddam Hussein—Egypt's and Iran's stock markets rose by roughly 6%, Turkey's by 18%, Israel's by 15%.

If there were futures markets trading in events—say "U.S. victory in two weeks" or "3% Middle East growth after the war"—investors could get back to pricing regular securities based on a company's fundamentals, while still hedging against risks of war, peace dividends, and the gray areas of terror in between. The benefits would accrue not only to investors, but to companies, which could then more efficiently allocate capital. Once futures markets priced external risks, businesses could hedge, and focus on their products and services—from education to telecom to biotech.

There has been plenty of ink spilled lately about market bubbles, but the fame of "Internet," "railway," "South Sea," and "tulip" crazes only underscores these as exceptions to the rule. If such drastic mispricing were common, financial markets would have long since disappeared into the footnotes of history books. The prosperity of countries democratizing their capital markets shows that allocating capital through public participation is far better for society than relying on dictators and bureaucrats to decide what projects are worthy.

The proposal that "specialists" would buy and sell futures contracts from self-financed accounts was not ideal. Specialists have rarely been the best way to price stocks and futures. For transparent pricing, the markets must be open to all, and not beholden to subsidies.

But as to the politicians' view that terrorists could profit from these new markets, the same laws that prevent terrorists going short on some stocks (airlines and hotels), and going long on others (surveillance and defense), would also prevent them from profiting in the new futures market. Defense officials could have monitored trading patterns to glean insights into the likelihood of certain events.

Money and fear: South Sea "market terror."

The question may more reasonably be how much we really want to know. For many years, an institution linked to the University of Iowa has run a futures market in elections. The predictions derived from prices set in these markets have often been far more accurate than polls—unsurprisingly, since people put their money where their thoughts were. At Tradesports.com, one can bet on the Democratic nominees in 2004. John Kerry is at the top at around 32 cents, Joseph Lieberman at around 15 cents and Hillary Clinton at about 4 cents. No wonder politicians would prefer to stay away from futures markets.

Just as insurance companies benefit from bilateral negotiations, and dislike futures markets that would transform pricing risks into a commodity, bureaucrats naturally feel their own role at risk from such a system. As it currently stands, the inability of markets to price certain risks prevents activities from being privately financed. People then turn to government for financing. Creating a strong and transparent device for hedging risk would strip away layers of power in Washington, returning it to the businesses and investors that power our economy.

Futures markets are not perfect. Nothing is. But a society will allocate capital—and people—better by better pricing risks, by pricing more of them, and by making the prices visible to all.

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