The Economist

The treacherous economics of defence

RFK's vaccine madness

Chinese brands: soft-toy power

Conference-panel hell

JUNE 28TH–JULY 4TH 2025

How to win the peace

Business

Photograph: Getty Images

After several false starts over the past decade, Tesla at last launched its robotaxi service, though it was a subdued affair. The electric-car company rolled out a small fleet of vehicles in Austin that picked up invited Tesla-friendly passengers. The driver's seat in the autonomous cars was left empty, though a safety worker sat in the front passenger's seat. There were a few bumps in the road. The National Highway Traffic Safety Administration reportedly got in touch with Tesla after videos posted on social media appeared to show several driving mishaps.

Think different

A giant merger in the advertising industry between Omnicom and Interpublic was given the go-ahead by America's Federal Trade Commission, but only after the companies signed a consent decree promising not to boycott platforms because of their political content. The FTC is investigating whether ad agencies have violated antitrust law by co-ordinating spending boycotts of conservative media.

Nvidia's share price hit a new record high, its first of the year, giving it a market value of nearly $3.8trn. The chipmaker's stock fell sharply earlier in the year amid wider investor concerns about tech companies' commitment to spending on artificial intelligence, but those worries have receded.

Niger said it would nationalise a uranium mine that it jointly owns with Orano, a French company. It is the latest in a series of nationalisations in Africa's Sahel region. Mali has placed a gold mine operated by Barrick under state control, and Burkina Faso has nationalised five gold mines recently.

America's National Transportation Safety Board issued an executive summary of its investigation into the incident in which a panel came off a Boeing 737 MAX 9 passenger jet that had just taken off from Portland in January 2024. The NTSB blamed the aerospace company for failing to "provide adequate training, guidance and oversight" to its factory workers. It also criticised the Federal Aviation Administration for being "ineffective". The full report will be published in the coming weeks.

Chart: The Economist

Israel's stockmarkets hit new records, as investors bet that the military action taken against Iran will make the country safer. Tel Aviv's TA 25 and TA 125 indices are up by 10% in the past month.

Oil prices remained volatile amid the conflict. Brent crude soared to over $81 a barrel, the highest in five months, before plunging below $68 as Iran's threat to blockade the Strait of Hormuz receded.

Donald Trump called on American oil companies to increase output in order to lower prices. “Drill, baby, drill,” the president exhorted, “and I mean now.”

Two court rulings decided that the firms behind generative artificial intelligence could use copyrighted books without permission to train their models. One judge said that Meta could continue to do so after finding that a group of authors who had sued it for using their material had made “the wrong arguments”. This doesn’t mean Meta’s behaviour was “lawful”, he said. A similar judgment found in favour of Anthropic against another set of authors, though the judge in that case said that Anthropic’s storage of 7m tomes in a “central library” was not fair use of the material and set a trial for December.

FedEx withdrew guidance on revenue and profits for its full fiscal year because of the uncertainty over trade with China. Freight volumes from China plunged in May when duties were slapped on small packages. Meanwhile, tributes were paid to Frederick Smith, who founded Federal Express in 1971 and has died at the age of 80. He ran the company until 2022, when he became executive chairman. Mr Smith started operations in 1973 with 14 small planes carrying 186 packages. Now FedEx ships 16m packages a day.

Despite pressure from Donald Trump to cut interest rates, Jerome Powell stuck to his guns and suggested to Congress that the Federal Reserve won’t do so until September, at the earliest. The Fed’s chairman said that the impact of tariffs on the economy will be clearer by then. Speculation continues to swirl that Mr Trump is about to name a replacement for Mr Powell, even though his term doesn’t end until May 2026.

Ditching the shuffleboard

Carnival cruise line issued a stellar set of earnings and raised its outlook. The company said that although it is not immune from current economic headwinds, business was proving to be incredibly resilient. It is helped by the popularity of cruise ships among the young. Around 67% of cruise travellers are Gen X or younger, according to an industry report, and 36% are under 40. Carnival offers many activities aimed at youthful passengers, such as “dive-in” movies at swimming pools.

How the defence bonanza will reshape the global economy

As they spend big, politicians must resist using one pot of money to achieve many goals

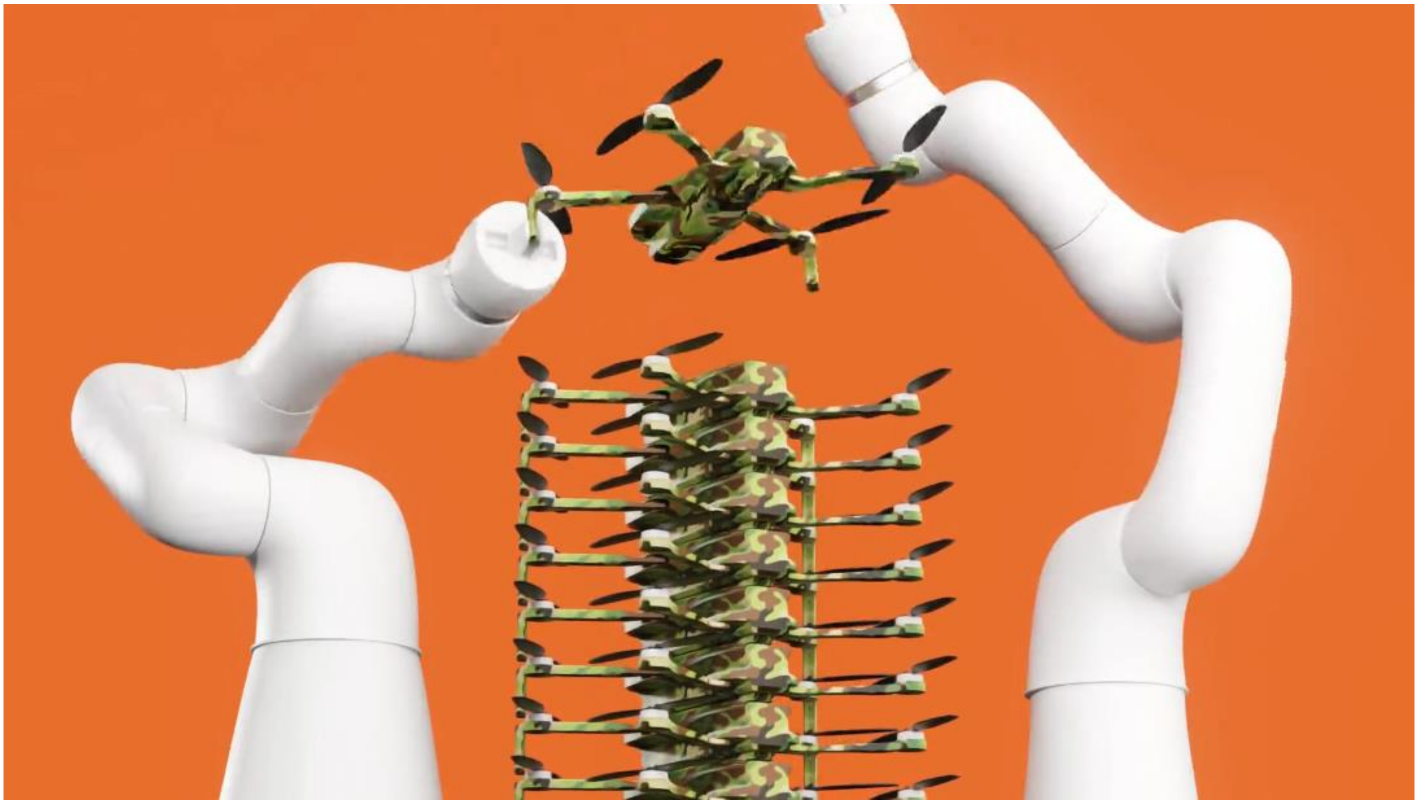

Illustration: Timo Lenzen

For the first time in decades, the rich world is embarking on mass rearmament. Wars in Ukraine and the Middle East, the threat of conflict over Taiwan and President Donald Trump's impulsive approach to alliances have all made bolstering national defence an urgent priority. On June 25th members of NATO agreed to raise their target for military spending to 3.5% of gdp, and allocated an extra 1.5% to security-related items (Spain insisted on a loophole). If they achieve that target in 2035, they will be spending $800bn more every year, in real terms, than they did before Russia invaded Ukraine. The boom goes wider than NATO. By one estimate, embattled Israel splurged more than 8% of its gdp on defence last year. Even doveish Japan plans to stump up.

Such vast sums could reshape the global economy, by squeezing public finances and shifting activity within countries. As politicians sell the benefits of rearmament to voters, many will claim that military spending will bring economic gains as well as security. Sir Keir Starmer, Britain's prime minister, promises defence will offer "the next generation of good, secure, well-paid jobs". The European Commission says it will bring "benefits for all countries". However tempting politically, such arguments are wrong. Using defence spending for economic objectives would be a costly mistake.

The most obvious economic consequence of bigger defence budgets will be to strain public finances. Debts are already high and the financial pressures on governments, caused by ageing populations and higher interest rates, are mounting. The average nato member, excluding America, will need to raise annual defence spending by 1.5% of gdp.

As a result other parts of the budget, such as social spending, will be squeezed, shrinking the peace dividend from the ending of the cold war. And cutting spending or raising taxes by the full amount is likely to be politically impossible, meaning that many governments will run higher deficits, too. Defence spending will therefore tend to raise interest rates and make the public finances more fragile, even as it makes countries safer from their enemies.

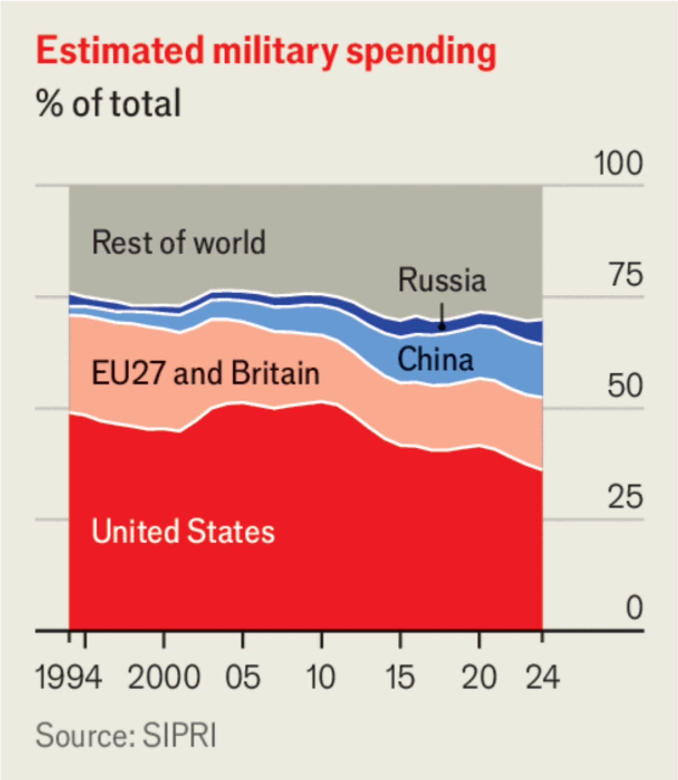

Chart: The Economist

What are the consequences for growth? Deficit-financed spending will provide a Keynesian fiscal stimulus, but it is likely to be modest—and unwelcome at a time of low unemployment and lingering inflation in the rich world. Moreover, defence spending is costly and lifts no one’s living standards directly.

Defence research and development, by contrast, could be more beneficial. Publicly funded innovation often has the effect of spurring private innovation; by one recent estimate, when defence R&D accounts for an additional 1% of an industry’s value-added, its annual productivity growth rises by 8.3%. Just think of the internet, or nuclear energy, both of which emerged from military research.

Spending on arms will also shift demand around the economy. Politicians hope that it might counter the effects of deindustrialisation, but they are likely to be disappointed. Defence production, like much other manufacturing, is now highly specialised and automated, meaning that rearmament is likely to create far fewer jobs than are being lost to new technology or foreign competition. By one estimate, higher defence spending in European NATO countries could create 500,000 jobs—a paltry number when set against the EU’s 30m manufacturing workers.

The nature of modern warfare only makes mass job creation less likely. Ukraine shows that a country does not need broad-based industrial policy to prepare for war. Making drones, which are inflicting the majority of casualties on the battlefield, is relatively simple. And the more artificial intelligence becomes important, say in guiding and operating those drones, the fewer jobs are created on assembly lines and the more rents accrue to tech firms.

Big defence budgets will present governments with trade-offs between security, efficiency and equity. As budgets grow, local officials, companies and unions may all clamour for the money to flow their way. But giving in would be a mistake. One of the problems with Europe’s defence spending is that too many countries want to make their own hardware. EU countries operate 12 types of battle tanks, for example, whereas America produces only one. Duplication is wasteful and hinders armies from being able to work together.

Governments have no duties more important than keeping their citizens safe. The fragility of the public finances means that they will need to be as efficient as possible in how they spend taxpayers’ money. Splashing the cash on favoured places and industries will only lead to more tax rises or cuts to social spending. To make a success of rearmament, governments will need to make an honest case to voters for spending for security’s sake. If they look to accomplish everything with a single budget, they will do nothing well. There is no point in boosting growth if the consequence is to be invaded.

Finance & economics
How to escape taxes on your stocks

Not that American investors need a guide—a booming industry is doing the job for them

Illustration: Álvaro Bernis

An investor's desire to minimise his dues is nothing new. "The avoidance of taxes", said John Maynard Keynes, "is the only intellectual pursuit that still carries any reward". What is new is the scale and speed at which the desire is transforming financial intermediaries, wealth management and even the notion of passive investing. Once the preserve of the ultra-rich, the drive to minimise taxes has reshaped America's financial system.

Everything from the "separately managed account" industry (with $2.7trn of assets under management) and robo-advisers (an estimated $1.2trn) to exchange-traded-funds ($15.5trn) now caters to an investor's desire to minimise taxes. Beneath these behemoths is a plethora of niche offerings, such as exchange funds and 1031 exchanges, as well as more sophisticated strategies such as "heartbeat trades", "box spreads" and "long-short dynamic tax-loss harvesting". Whereas tax advice was once dispensed by a well-dressed fellow in a wood-panelled office, today it arrives through bespoke algorithms.

Asset managers have embraced the shift with gusto. JPMorgan Chase last year said that its newish tax-strategy line was its fastest-growing business; BlackRock is a big player; Neuberger Berman, which on June 23rd announced a new "tax-managed long/short" strategy, is another. Fintech platforms, such as Betterment and Wealthfront, and boutique firms built upon tax efficiency, including Alpha Architect, NDVR and Quantinno, are keen. In pitches to clients, even large investment funds such as AQR Capital Management and ARK Invest now focus on after-tax returns, rather than pre-tax outperformance.

The modern playbook for avoiding the taxman uses old techniques in new ways. Chief among them is the treatment of capital gains. Investors are taxed on the difference between the sale price of an asset, such as a stock, and its original purchase price. Since the levy applies to net capital gains across an entire portfolio, financial-services firms noticed that they could lower their clients' tax bills if they realised losses alongside gains. Thus arose the strategy of "tax-loss harvesting", which involves investors selectively selling underperforming assets, often with the intention of repurchasing them soon after.

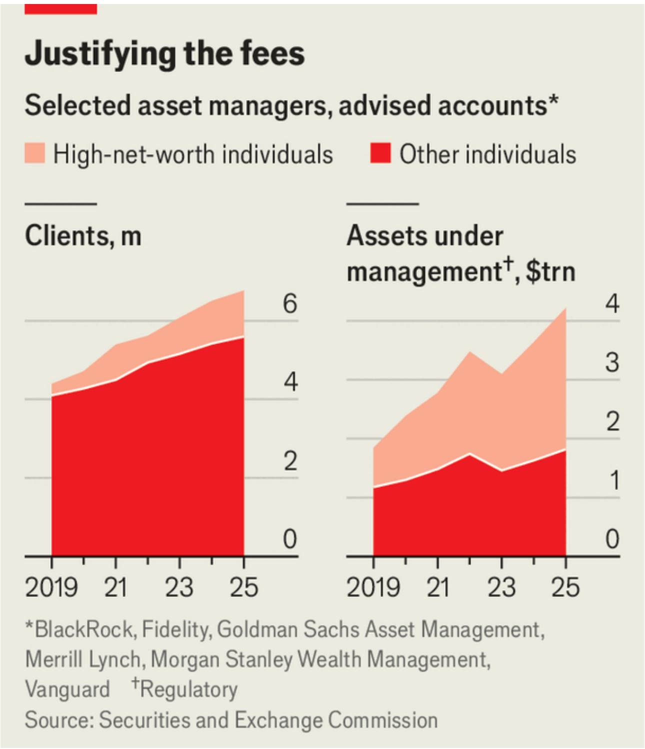

Chart: The Economist

Such strategies are more effective when investors have control over their investments, exposure to lots of assets and can automate the process of selling and repurchasing. This is what many new products offer. Take separately managed accounts (SMAs), which are owned by individuals but overseen by asset managers. Since they hold securities directly, rather than in a pooled fund, and can be tailored to each investor, they fast became a crucial tool for the rich after being offered by banks in the early 2000s. Growth has exploded recently. Since acquiring Aperio, a specialist, in 2021, BlackRock has overseen a more than 20% year-on-year rise in the firm's SMA assets. Combined assets in SMAs held at BlackRock, Goldman Sachs, Morgan Stanley and JPMorgan were worth $1.4trn at the end of last year—roughly $400bn more than those under management by the world's 20 largest hedge funds.

Investors seeking the benefits of SMAs without the hefty minimum investments or need for customisation may find their way to direct indexing or robo-advising. As the name suggests, direct indexing involves holding the individual stocks that make up an index, rather than the whole index. Since indices will inevitably contain some underperforming stocks, investors can sell these for tax offsets—even when the broader market is rising. Robo-advising automates the process of identifying losing positions and scheduling repurchases, sparing investors the need to do so themselves. These products have grown fast, too. In the past two years, Vanguard's robo-advisory platform saw its assets under management rise from $6bn to $21bn. Some $865bn has been invested in direct indexing. S&P Global, a data firm, expects that figure to reach $1.1trn by 2028.

Due diligence

A second pillar of the tax code explains the rise of the ETF over its ageing cousin, the mutual fund. For all their benefits, mutual funds are remarkably tax-inefficient. When an investor redeems shares, the fund may have to sell appreciated assets, triggering capital gains for all shareholders in the fund. One way to think of an ETF, the joke goes, is as a mutual fund that does not pay taxes. Investors trading in and out do so on a secondary market with other investors, without triggering any sales by the fund itself. More importantly, even when an ETF does need to trade on the primary market—say, to accommodate inflows or outflows from large investors—it typically does so by handing over a basket of appreciated stocks in exchange for ETF shares. Because this redemption is "in kind", and no cash changes hands, the Internal Revenue Service looks the other way.

This quirk may seem insignificant, but the benefits it confers are profound. Derek Horstmeyer of George Mason University and co-authors compared the post-tax returns of ETFs with those of mutual funds. They found an average gap, or "tax alpha", of 0.2 percentage points a year, which is more than the total decline in average fees on passive funds over the past 30 years.

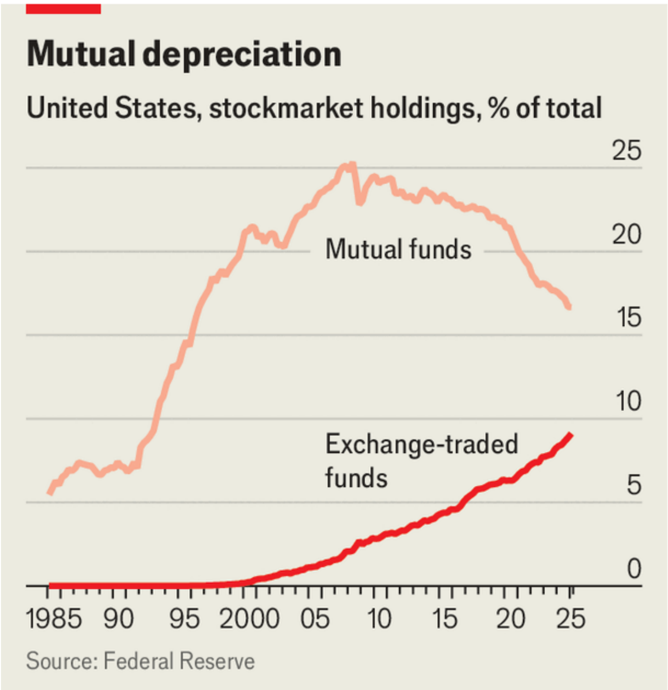

Chart: The Economist

This has saved investors hundreds of millions of dollars. It has also transformed the structure of corporate ownership. ETFs now hold over 9% of all American companies' stocks, up from 0.2% in 2000. The less tax-efficient mutual-fund sector, by contrast, peaked in 2008 at 25% of stockmarket ownership and has since fallen to 17%. Although ETFs have other benefits, such as liquidity and low fees, Rabih Moussawi at Villanova University and co-authors find that the different tax regimes account for most of the reallocation between ETFs and mutual funds. They show that, even controlling for fees and performance, the relative tax burden of mutual funds against ETFs is strongly predictive of outflows. On top of this, tax-sensitive investors are more likely to invest in ETFs.

Some strategies are trickier. Many explicitly tax-aware ETFs, which have burgeoned in recent years, seek to replace dividends (taxed in the year of receipt) with capital gains (taxed on sale), or to avoid interest income (taxed even more) altogether. But even sophisticated strategies tend to layer or enhance a smaller set of core techniques. Want to combine in-kind redemptions with tax-loss harvesting? A "heartbeat trade" allows ETF exchanges to swap assets that have gained a lot for those that have gained less. Not content to wait for losses to appear in a portfolio? An investor may pursue a "long-short" tax-loss harvesting strategy, ensuring that one of two legs always has a loss to be harvested.

If the desire to minimise taxes is old, what explains the recent explosion in the use of such stategies? It is not because of a change to the rules. The wash-sale law, which governs how soon investors can repurchase assets after harvesting a loss, has been on the books since 1921. The legal basis for the in-kind redemption mechanism of ETFs dates to 1986. And although capital-gains-tax rates do fluctuate, they have remained fairly constant in recent years.

Stranger still is that many vehicles at the core of the tax-aware industry were not set up with tax efficiency in mind. When ETFs were launched in 1990, it was to allow investors to trade throughout the day. Robo-advisers set out to automate financial advice rather than tax-loss harvesting. Even SMAs were about customisation for the rich rather than careful tax planning. Evolutionary biologists use the term “carcinisation” to describe the curious tendency of crustaceans to independently evolve into crab-like forms. Something similar seems to happen with financial products.

What has changed is technology. Consider a strategy as conceptually simple as direct indexing. In the pre-digital era, manually harvesting across dozens or hundreds of individual stocks would have been a nightmare to do even once a year, let alone constantly. Now the tracking, sale and repurchase of assets can be handled by a simple algorithm and click of a button.

Less certain than death

Another barrier was transaction costs. Unless an investor parks his money in a passive ETF, most tax-aware portfolios require high turnover. Investors must regularly sell losers and repurchase them no sooner than 30 days later, all while trading back towards their desired index exposure. Such churn once imposed costs that would have wiped out any tax advantage. A study published in 2000 by Brad Barber of the University of California, Davis, and Terrance Odean of the University of California, Berkeley, found that, for some retail traders in the early 1990s, the average round-trip trade with a value of more than $1,000 incurred 3% in commissions and a 1% in bid-ask spread (essentially the transaction cost of a trade). Today commissions are close to zero and bid-ask spreads for leading stocks are often 0.15% or lower.

Such “supply side” factors would have mattered little were it not for a commensurate surge in demand for tax minimisation. The cumulative return on the S&P 500 index from 2010 until the end of 2024 was about 600%, which has left Americans holding enormous unrealised gains. With a generation of baby-boomers now looking to convert these into cash for their retirement, it is little wonder they have sought to do so while minimising their payments to Uncle Sam. Many gains are highly concentrated, too, driven by high-performing stocks such as Nvidia, a chip designer, and Tesla, an electric-car maker, or by ownership of whole businesses. Without planning, realising gains—whether to cash out or to rebalance a portfolio—can trigger an unpleasant tax bill.

Last, wealth managers' incentives have aligned with technological progress and rising demand. The rise of index-fund providers such as BlackRock and Vanguard, the subsequent collapse in fees and the difficulty of outperforming the benchmark has left many asset managers looking for new ways to justify their charges. Tax-aware strategies offer one such way.

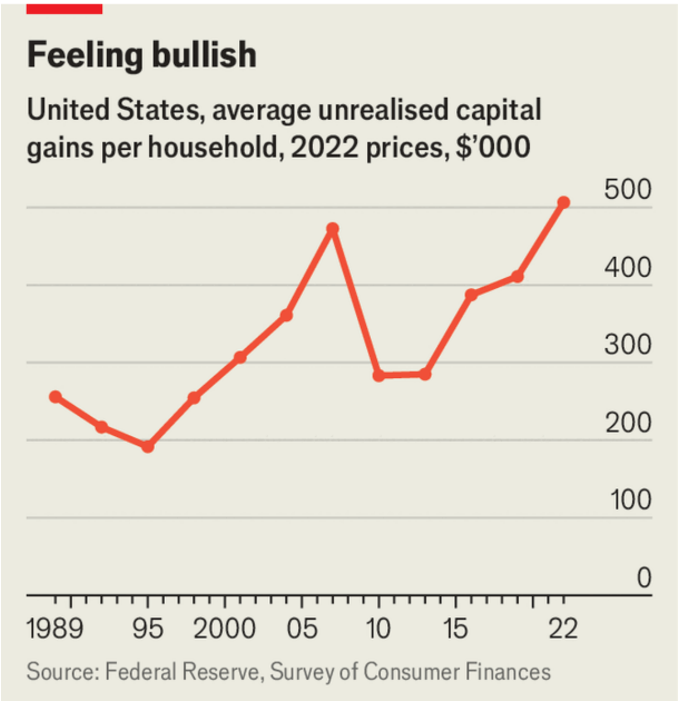

Chart: The Economist

Economists may question whether the industry's tax-aware evolution is good for markets. After all, it is difficult to argue that sheltering portfolios in tax-efficient wrappers furthers the central aims of finance, namely price discovery and the efficient allocation of risk. Moreover, the process is a zero-sum game: what investors gain, the government forgoes. At the same time, however, there is some good news. The yen for tax efficiency is unlikely to distort markets much and—to the extent that individuals are better stewards of capital than the government—is perhaps even beneficial. Just as the decline in management fees has been celebrated, so should a lower tax burden on investors.

The more salient criticism of the new approach is not that it distorts markets, but that its benefits are skewed towards those who need them least and (in some cases) may be overstated. Stockmarket ownership is remarkably concentrated. Some 40% of Americans hold no stocks at all; many who do invest do so through vehicles that already offer lower tax contributions, such as pensions. What is more, precisely since taxes on capital gains are levied in a progressive manner, rising with the size of the gains in question, the ability to escape them will disproportionately benefit investors in higher tax brackets. A paper by Nathan Sosner of AQR Capital Management and co-authors suggests that returns achieved by high-net-worth individuals can exceed those of retail investors by as much as 1.4 percentage points a year. For its part, Vanguard quotes different tax-savings estimates for ultra-high-net-worth clients and merely high-net-worth ones.

Although retail investors unquestionably benefit from the tax efficiencies of ETFs, the case for moving into more advanced strategies is less clear. Many tax-aware funds charge higher fees than their passive peers—often 0.3-0.5 percentage points more of the portfolio a year. That may seem modest but, in perpetuity, it represents as much as a 5% haircut on a portfolio's value. Add to that the tracking error when straying from an index, along with the complexity of pairing gains with losses, and many investors are better off sticking with a passive ETF. And as investors harvest losses to offset capital gains, they leave a large tax bill for the future, having deferred, not avoided, levies.

For years, most financiers viewed investment taxes as a fixed cost to be paid, rather than as an active force that shapes markets. The recent explosion of strategies and vehicles drastically changes the picture. Many have come to see taxes as an important constraint when constructing a portfolio. As Charlie Munger, the former vice-chairman of Berkshire Hathaway, a mighty conglomerate, once quipped: "Show me the incentive, and I will show you the outcome." It does not take as astute an investor as Munger to see the connection between the desire to avoid tax and the shape of the modern market.

Why commodities are on a rollercoaster ride

Pity Tommy Norris. And his real-world equivalents

Illustration: Álvaro Bernis

According to Tommy Norris—a tough oilman with a complicated love life, played by Billy Bob Thornton in "Landman"—the ideal price for a barrel of oil is $78. At that level, he explains, producers make a healthy profit and have spare money for exploration, while consumers are broadly comfortable. Today the price of Brent crude, the global benchmark, is $65. Not only is that too low for Mr Norris, it is also too volatile: in recent weeks prices have swung in response to missiles in the Middle East.

Most industries have to contend with long-running price trends. Consumer electronics, for example, have been getting cheaper in real terms for decades, as manufacturing productivity has improved. The real price of labour-intensive services, such as education and health, has generally risen, owing to Baumol's cost disease (the tendency of wage pressures to rise in line with earnings across the whole economy). By contrast, physical commodities, such as agricultural products, energy and metals, lack a clear long-run trend. They have an annoying tendency to overshoot ideal output during spectacular booms, and then to sink below it during equally striking busts. As Mr Norris is keen to point out, this matters since the raw materials are found in everything: “tennis rackets and lipstick and refrigerators and antihistamines”.

Recent disturbances to the oil price—this time prompted by war—will be familiar to weary oilmen. For although oil has long been a tricky product, recent research from the World Bank suggests that, in recent years, things have become much worse. Today’s boom-and-bust cycles are shorter and more extreme.

What has changed? The main driver of the commodity cycle used to be found on the supply side. Something has to be extracted from the earth or grown from scratch. That results in long lead times and requires lots of capital. An offshore oil rig can take years to get up; even the shale-extraction process lasts months, not weeks. The metaphor of “striking gold’ is a little misleading: in reality, it is ten to 20 years from discovery to extraction. Thus supply struggles to respond to price signals, leading to over-investment during booms and persistent excess during slumps.

Inventory dynamics also contribute to the cyclical nature of commodities. In many cases, goods are either expensive to store or, in the case of agricultural commodities, perishable. Slim stockpiles mean that even short-term imbalances in supply and demand can cause large price variations. Financial speculation contributes, too, often intensifying a given market mood. More generally, demand for commodities is closely bound to the global business cycle. And there is always the possibility of a new war.

The World Bank’s researchers used an algorithm to identify turning-points in the prices of 27 commodities from 1970 to 2024. On average each experienced 14 about-turns over the five-decade period. Slumps lasted for a little under four-and-a-half years on average; booms for just over three. Although slumps tended to endure for longer, the size of the price move in both parts of the cycle tended to be similar. Individual commodities were in the same cyclical phase about two-thirds of the time, reflecting the impact of the global business cycle. Industrial metals and energy showed lots of correlation. Agricultural commodities, by contrast, tended to move independently, being subject to idiosyncratic, localised shocks such as weather disruption and disease outbreaks.

From 1970 to 1985 cycles were mostly driven by supply shocks, especially in energy. Then, between 1986 and 2001, markets became more stable, with longer cycles driven by technological advances in resource extraction, as well as a more liberalised global trading system. Volatility began to creep back into the picture in the 2000s. Since 2020, it has intensified. Booms now last an average of 24 months and slumps just 23 months. The peak-to-peak cycle has halved from 90 months to 45 months. As such, the World Bank identifies a new commodity regime.

Some of this shift has been driven by events, namely a combination of the covid-19 pandemic, the shock of Russia’s invasion of Ukraine and large swings in monetary policy over the past five years. But longer-term structural changes also appear to be playing a role. The global energy transition, as governments across the rich world pour billions into green energy sources, is leading to much higher demand for critical minerals such as nickel and lithium. At the same time, more frequent extreme weather has raised supply risks, especially in agriculture. The increasingly fragmented nature of the global economy, with rising trade barriers, has also disrupted the commodities trade. Concentrated production, limited supply-chain diversification and low demand elasticity mean its markets are especially vulnerable to protectionism.

When hammer hits hand

This has implications for governments around the world. According to the World Bank, two-thirds of emerging-market and developing economies rely on commodities for a significant share of their exports, fiscal revenues and economic activity. A more volatile cycle is a headache for these countries’ policymakers, lowering the chance that they will be able to achieve solid growth.

It is also a challenge for rich-world central bankers. Historically, they have “looked through” commodity-driven price movements, instead preferring to concentrate on core measures of inflation, which mostly exclude energy and food. Given that commodity booms and busts between 1970 and 2020 usually saw price movements of a similar size, that made sense. However, if the upswings are now larger than the downswings, as appears to be the case, things become much more complicated.

Mr Norris, and his real-world counterparts, will also be wincing. The change in the dynamics of the commodity market means that the oil price will spend even less time in its sweet spot.

The dream scenario for prediction markets?

Polymarket and Kalshi are soaring in popularity. With a few tweaks, they could really take off

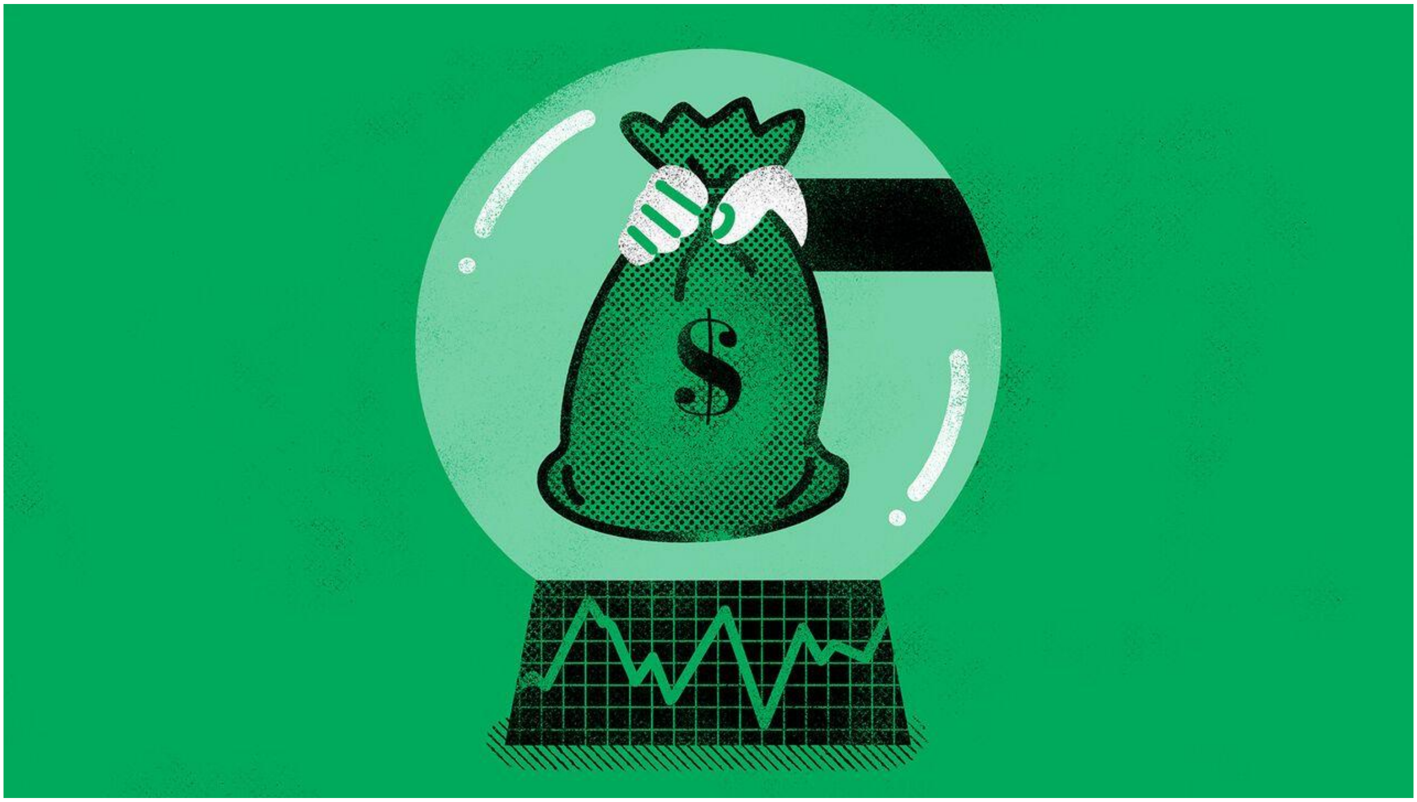

Illustration: Satoshi Kambayashi

If you could invent something to fulfil an economist's dream, it would look an awful lot like a prediction market. A world where every uncertain future can be priced, hedged and insured against? Kenneth Arrow and Gérard Debreu would approve. A market mechanism to co-ordinate the decentralised wisdom of crowds, ensuring the accuracy of such prices? Adam Smith and Friedrich Hayek sought just that.

In recent years, the fantasy has crept closer to reality. Platforms that allow users to speculate on current affairs and more have seen remarkable surges in volume and visibility. On Polymarket, the largest, traders wagered over $1bn last month, up from $63m a year before. In both the court of public opinion and the actual courts, exchanges have scored significant victories. Most important, their forecasts have held up: where opinion polls cast November's presidential election as a toss-up, prediction markets priced in a victory for Donald Trump. More recently, they did a better job than other sources at predicting Israel's strikes on Iran and the result of New York City's Democratic mayoral primary.

Yet despite having proved their worth as a way to discover information, prediction markets have further to go when it comes to fulfilling their full economic promise. That is true both in their ability to help financial institutions hedge and share risk, and as a meaningful addition to capital markets. Goldman Sachs, a bank, may cite prediction markets in its research, but active trading by institutions of its size remains virtually non-existent on the platforms.

The absence of serious capital reflects several factors. One is scale. Although presidential races draw widespread interest—some $3.7bn was wagered on Polymarket in the most recent—other events attract less action. Consider inflation, an important economic variable. The market for Treasury inflation-protected securities, which reflect investors' expectations for consumer prices, is worth nearly $2trn. By contrast, the most active financial market on Polymarket ("What price will bitcoin hit in June?") has welcomed wagers worth just $22m.

Low liquidity poses a number of challenges. The biggest investors may have hedging needs that exceed the size of the markets themselves. Moreover, thin markets are vulnerable to price manipulation by large traders, as has happened several times in prediction markets.

Traditional finance may not offer markets for all possibilities, but it comes closer than is often appreciated. Inflation swaps and federal funds futures forecast inflation and interest rates, respectively. Even non-financial events are well-priced by traditional markets. Commodity futures predict the weather; the price of Brent crude closely tracks geopolitical developments. For many in finance, prediction markets offer, at best, marginal improvements on existing tools.

If they are to take up this offer, financiers need a firmer regulatory footing. Polymarket is off-limits to Americans, having been accused of running an unregistered derivatives-trading platform. Kalshi, though approved, is mired in disputes over which contracts are legitimate futures and which are gambling. Wrinkles are to be expected as regulators confront hard questions, such as whether insider trading should be allowed to improve accuracy. Although regulators under Mr Trump have become more open to prediction markets, it is uncertain whether future administrations will follow his lead.

Some platforms are not helping their cause. They have, for instance, lobbied regulators to put sports betting and event contracts on an equal legal basis, which may boost revenues, but risks tying economically meaningful markets to more controversial retail offerings.

Because existing financial markets are so well-developed, platforms would need to prioritise underserved areas that align with financial institutions' hedging needs, rather than catering to niche or meme-driven speculation. Many real-world risks—ranging from surprise GDP readings and legislative outcomes to rare climatic events and the cost of compute for artificial-intelligence firms—could be emphasised. Doing so might mean curtailing other markets. Credibility suffers when contracts about future interest-rate cuts sit alongside such wagers as "Will Jesus Christ return in 2025?" (3%) or "Will the 'Smurfs' Rotten Tomatoes score be above 60?" (26%). What odds should you put on prediction markets taking these steps? Your columnist would say about 10%.

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