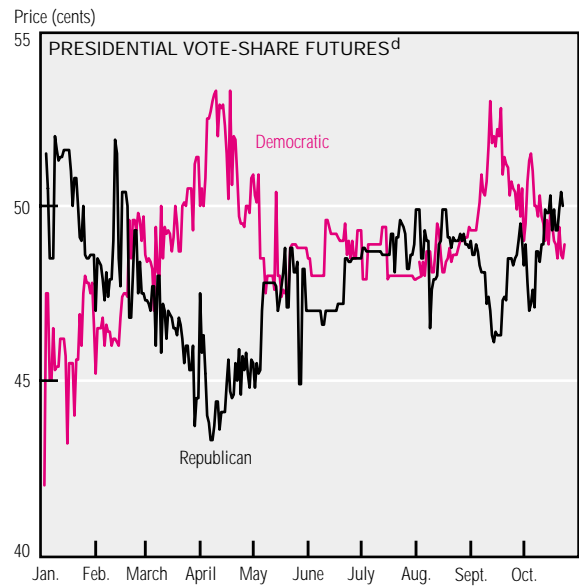
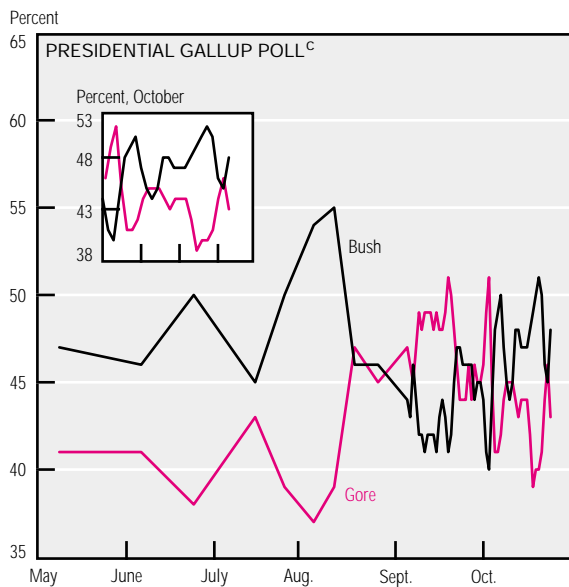
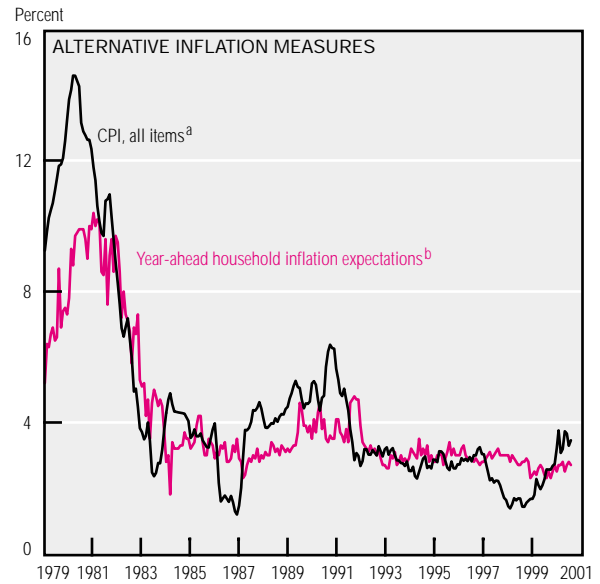
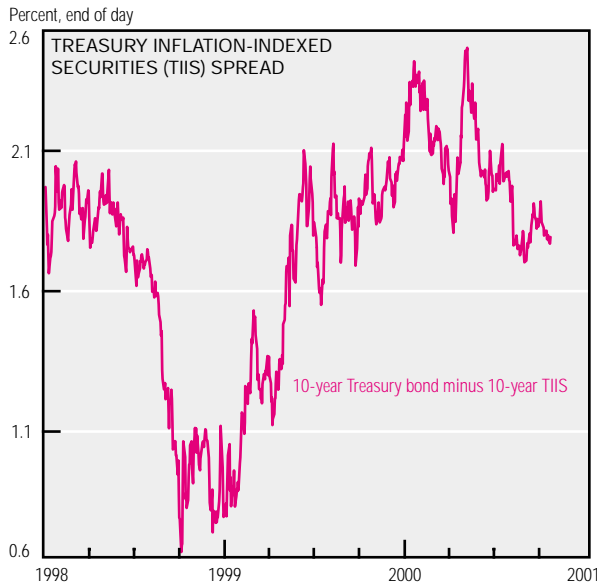


Expectations, Markets, and the “Political” Economy



a. Year-over-year percent change.

b. Median expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*, lagged 12 months.

c. Beginning September 5, 2000, three-day rolling poll results among likely voters are displayed. Previous polls were conducted at irregular intervals. Values may not sum to 100% because results for all candidates are not shown. Last plot is October 25.

d. Reform Party contracts (not shown) also trade on the IEM's 2000 Presidential Vote-Share Market. Last plot is October 25.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; University of Iowa, Henry B. Tippie College of Business; Bloomberg Financial Information Services; and the Gallup Organization.

When it comes to measuring people's expectations, economists are often skeptical of the direct approach—asking them. Instead, economists prefer information derived from markets, where people have money on the line and thus have incentives to use information carefully and to reveal their true beliefs.

The federal funds futures market provides a market-based gauge of future monetary policy. Likewise, the Treasury inflation-indexed securities (TIIS) market provides one measure

of information about inflation expectations. Coupon and principal payments of TIIS are linked to the Consumer Price Index (CPI), thereby ensuring investors a return that is not influenced by inflation—that is, a real return. The spread between the 10-year TIIS and the 10-year Treasury bond provides a measure of market participants' expectations for average CPI inflation during the remaining time to maturity.

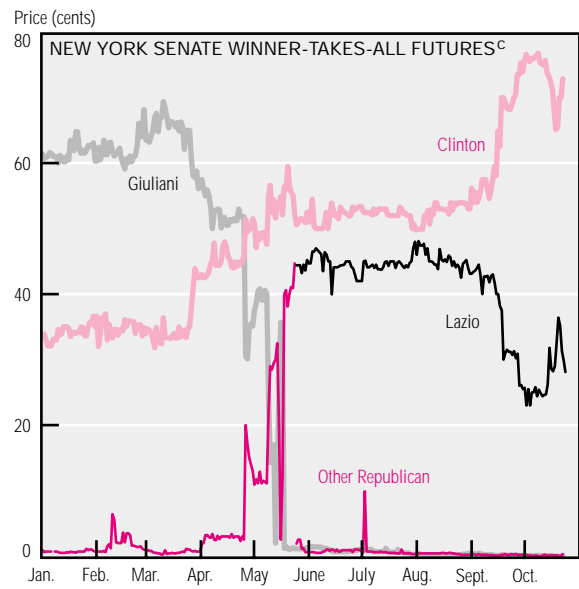
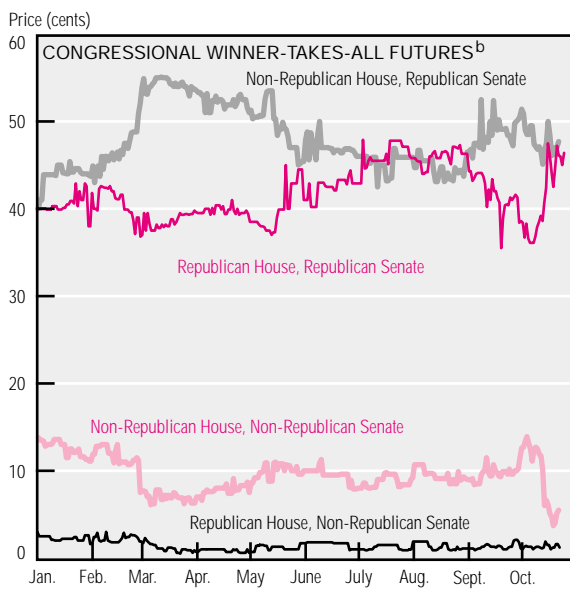
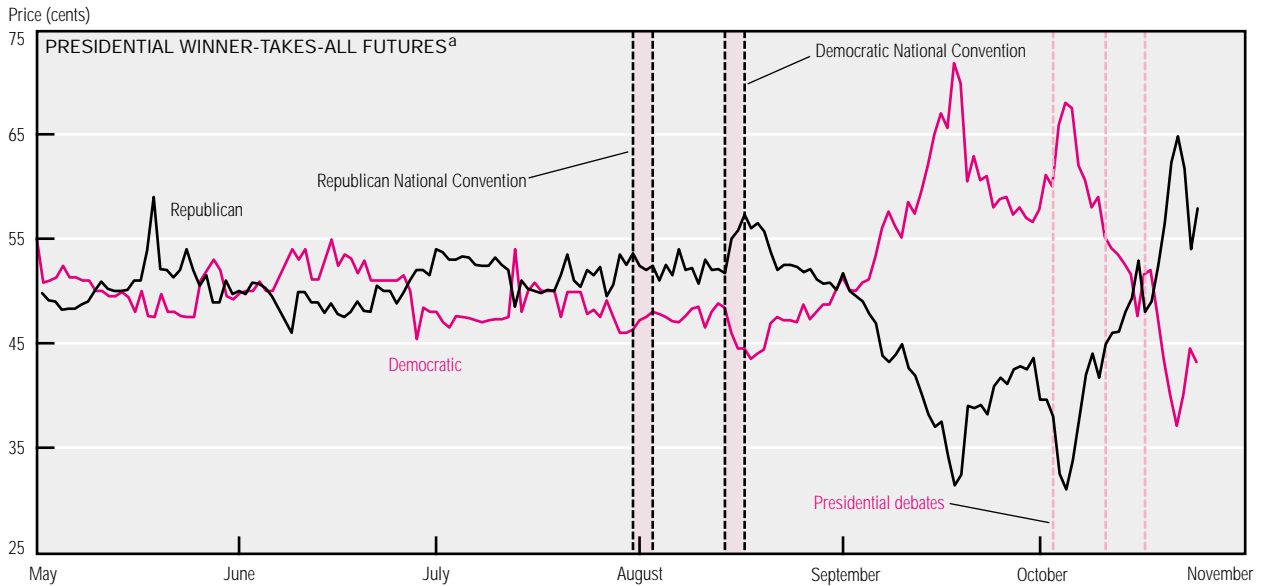
Market information can also be used to gauge expectations about

other events, such as political elections. While most people are familiar with national polling organizations such as the Gallup Poll, fewer know about the Iowa Electronic Markets (IEM), a small-scale futures exchange where contracts' values are determined by political perceptions.

The IEM operates a Presidential Vote-Share futures market which pays \$1 times the vote share of the contract party's (Democratic, Republican, or Reform) nominee. In other words, the futures contract trades at

(continued on next page)

Expectations, Markets, and the “Political” Economy (cont.)



a. Reform Party contracts (not shown) also trade in the IEM's Presidential Winner-Takes-All Market.

b. Contract liquidation values are determined by the number of seats won by the Republican party in the U.S. House of Representatives and Senate.

c. Contract liquidation values are determined by the outcome of the U.S. Senate election in New York.

NOTE: Last plot for all charts is October 25.

SOURCE: University of Iowa, Henry B. Tippie College of Business.

the percentage of the popular vote that market participants believe each nominee will garner.

In the IEM, one can also purchase a contract that pays \$1 if the candidate of the contract party becomes president, and pays nothing otherwise. This is known as a winner-takes-all market. The share price for each party can be interpreted as the expected probability of that party's candidate winning. On September 17, for example, the contract for the Republican candidate was trading at

34 cents. If market participants on that day had felt that George W. Bush's chance of winning the election was greater than 34 percent, they would have bought more Republican shares, driving up the price of the Republican contract.

Markets can be straightforward, like the Presidential Winner-Takes-All Market, where payoffs are determined by which candidate wins, or more complex, as in the Congressional Control Winner-Takes-All Market, which offers four contracts

defined by whether the Republican party retains control of the House and Senate. If carefully designed, markets can even accommodate surprise events: In the New York Senate Winner-Takes-All Market, for instance, the withdrawal of early favorite Rudolph Giuliani and Congressman Rick Lazio's acceptance of the GOP nomination were accommodated by spinning off another contract.