BY PETER SVENSSON, AP Technology Writer

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NEW YORK - Just before U.S. financial markets were roiled by a global credit squeeze this summer, an equally dramatic financial crisis threatened "Second Life," the much-hyped online world.

On July 25, the company controlling "Second Life" announced that it would no longer allow gambling. Economic activity was cut by nearly half as gambling halls shut down.

That's a recipe for disaster in any economy, with job losses and a possible currency collapse, but the online world stayed on an even keel. It's just one example of how economists and virtual worlds are teaming up, to mutual benefit. Outside "Second Life," a game company just hired its first full-time economist. Another economist, coming from the academic side, believes that just as virtual economies need economists, so economists need virtual economies — to experiment with.

The "Second Life" equivalent of Bernanke is John Zdanowski. He's the chief financial officer at Linden Lab, the privately held company that runs the world. Using "Second Life" software, he spoke to The Associated Press as an "avatar," or 3-D representation, in Linden Lab's virtual headquarters.

Before the gambling crackdown, visitors (or as the company calls them, "residents") exchanged about 2 million U.S. dollars a day in "Second Life." That dropped to $1 million shortly after.

Gambling wasn't quite as important to the world's economy as those figures indicate, Zdanowski said. "Second Life" is considerably more than an online Las Vegas — it's a place for socializing, sex games, advertising and other activities enabled by a world.
where residents can, with sufficient skill, create almost anything they want out of thin air.

Gambling inflated the economic activity because it meant small amounts of money changed hands relatively quickly, often several times a day, like at a poker table.

But the gambling shutdown was still a potential problem for economy, because "Second Life" has its own currency. The Linden dollar is convertible to U.S. dollars at an ostensibly floating exchange rate.

Losing even 10 or 20 percent of its real economy set it up for a currency crisis, as gamblers and gambling hall operators tried to cash in their gains for U.S. dollars and put their money to use elsewhere.

If the exchange rate started to plummet, remaining, non-gambling residents would also feel compelled to trade their virtual dollars for real ones, making the currency nearly worthless. Zimbabwe is currently struggling with that kind of hyperinflation. But in "Second Life," that's not what happened.

"The reason it hasn't hit the exchange rate is that we were exercising one of the controls we have," Zdanowski said.

Noticing that residents' behavior is strongly affected by the direction of the exchange rate, Linden Lab has for more than a year put a ceiling to the value of its currency. It's done that by selling Linden dollars on the currency exchange for around 270 to the U.S. dollar, and that's where the exchange rate has stayed since then. In a year, the company has made about $5 million on this trade.

Like China, "we basically manage the supply of our currency so that the exchange rate stays fixed against the U.S. dollar," Zdanowski said.

With visitors taking money out of the world because of the gambling shutdown, Linden Lab simply stopped selling its currency to compensate for the greater supply of Linden dollars for sale on the exchange.

If the supply needs to be reduced further, for instance if the popularity of "Second Life" starts declining, Linden Lab could introduce other measures, Zdanowski said. It could start accepting Linden dollars rather than U.S. dollars for some of the monthly fees it charges "landowners" in the world. That gives the company a very effective, but costly, way to soak up money.

However, Linden Lab doesn't guarantee the value of the Linden dollar — it could simply decline to spend money to prop up the virtual currency.

Eve Online, an online science-fiction game run by CCP hf of Iceland, has avoided some of the complications of having an online currency by banning its conversion to real money. Yet the company this summer hired its first full-time economist to keep tabs on what goes on inside the game.

"My job will be to disseminate good-quality, consistent information for the player base so they can make their decisions on production and mining and market rates," said Eyjolfur Gudmundsson, who has a Ph.D. from the University of Rhode Island.

The game has about 200,000 players, who form corporations, organize banks and even defraud one another. Gudmundsson will be looking at whether CCP should facilitate the formation of more complex financial institutions, like banks.
He also hopes to cultivate relationships with real-world academic institutions that want to use Eve Online for their research and teaching.

"One example can be that business students always have to develop a business or strategic plan in their studies. But they very rarely get the opportunity of actually following it through. Within a virtual economy, that would be no problem," said Gudmundsson.

Ted Castronova, an economist at Indiana University in Bloomington, is working on a related project: a virtual world based on the works of William Shakespeare, to be used as a "sandbox" to try different ideas in economy, sociology and political science.

In contrast to sciences like physics and medicine, where research is based on experiments, "in the social sciences, we have endless argument, with nobody every coming to firm conclusions" about large-scale things like the best way to run a country, said Castronova.

"There's nothing but fighting about stuff like 'how high should the overall income tax rate be for an entire economy?' No one has done controlled experiments on that question."

Castronova envisions running two or more copies of "Arden: The World of William Shakespeare" and varying conditions slightly between them to study the differences. For instance, he believes the worlds could be used to study the effect of money supply on interest rates.

"I think virtual worlds make it possible that in the next three or four hundred years we could see advances in social science like we've seen in the natural sciences in the past 300 years," Castronova said.

Funded by a MacArthur Foundation "genius" grant, "Arden" is in its early testing stages. Among its economically focused characters is, of course, Shylock, the Merchant of Venice.

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On the Net:

http://www.secondlife.com

http://www.eve-online.com

Synthetic Worlds Initiative at Indiana University: http://swi.indiana.edu

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