

Economics 2.0? A business primer on virtual worlds

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In August 2007, the digital world experienced a first: a genuine [run on a bank](#) located on the “[virtual world](#)” Second Life. As depositors rushed to withdraw their funds from the shadowy Ginko Financial, their predicament drew much attention. But far from identifying it as a calamity, to many commentators it confirmed the faithfulness of the computer simulation: after all, the real world had long experienced insolvencies, too.

But one can also see this collapse as a test of the economic reality behind the booming “[Web 2.0](#)”, the trendy but vaguely defined set of digital operations centred on interactive and collaborative activities. Web 2.0 has brought a new lease on life to the gold rush wing of the digital economy. It is easy to accept that the new activities are exciting sociologically, aesthetically, and culturally. But are they, this time around, also a business?

Because Web 2.0 is such a vague and sprawling concept, let's focus on one of its flagships, virtual worlds. One consulting group optimistically forecast that 80 per cent of internet users by 2011 will spend time in a virtual world. After major business magazines featured the largest of them, Second Life, on their cover, nobody, it seemed, wanted to [be left behind](#) in the old first world. Reuters established a news bureau on the site. The Swedish government built an [embassy](#). [Congressmen](#) gave virtual speeches.

But can this virtual world sustain itself economically? Or is it fundamentally a high-tech Ponzi scheme in which early participants reap the benefits from later arrivals? There are at least seven business models in a virtual world:

1. [Marketing Real Products](#)

A reality check is useful. At the moment of this writing, exactly 36,490 people worldwide were logged on to Second Life. That is about the same number as TVs turned on at the same time in Rapid City, SD, or in Zanesville, OH - not exactly huge markets. There is a mismatch between the [actual user base](#) and the size required to sustain the archipelago of specialised virtual islands. Running a quality corporate island can cost \$500,000 per year, and the returns, beyond those of exploration and short-term buzz, are uncertain.

2. [Selling Virtual Products \(V-Commerce\)](#)

It may seem strange to [sell virtual objects](#) such as imaginary shoes and belts. Why would anyone pay for a computer-depiction of a product? But there is nothing unusual here. Intangibles are regularly traded, as are postage stamps and baseball cards. But is this a profitable market? If entry is open, supply unlimited, provision competitive, and marginal cost near zero, then the price of these products will drop to near zero. The exception is where the product is truly unique, which will rarely be the case for more than a brief period, or where the owner of a dominant virtual world successfully limits competition among suppliers.

3. B2B Services to Virtual Operators

Examples are software programs for [virtual facilities](#). IBM and Electric Sheep are two suppliers of services to retailers. Small [software](#) suppliers abound. But here, too, competitive prices would be low, and retailers' willingness to pay is constrained by their own limited profitability.

4. New-Style Services

[Sex](#) and [gambling](#) are at the forefront, as is often the case with new media. Other examples are [education](#) and [training, meetings](#) and collaborations, recruiting and customer service, [market research](#) and product testing. These applications are imaginative and promising. But most of them do not require all-purpose "public" virtual worlds and could be provided on specialised "private" sites that offer their sponsors greater control and security. Soon, users' avatars will often be able to jump from one private site to another, reducing the advantage of the more general worlds.

5. Media Content Distribution

Virtual worlds are a good way to offer and promote [music](#), books, or [interactive games](#), and they are a way of [reaching and immersing participants](#). Some new diversions will be creative and innovative. Some will be [violent](#) and [adult oriented](#). Others will provide real [gambling](#). Therefore, the providers of the virtual world platforms will inevitably be called to police users and uses. And that creates [other problems](#).

6. Creating Community

People come to a virtual world because others are there, too. The [community](#) that is generated then is an asset of value, as one can see from the large amounts paid for the acquisition of communities such as ICQ, YouTube, or Facebook. The community's cumulative network effects on the value of the virtual world are important enough that eventually, people will actually be paid to visit it. This will be a continuous financial drain, up to the point of sale.

7. Controlling the Virtual World

For all the promotional rhetoric that Second Life is owned by the residents, [it really isn't](#). The basic software is controlled by the privately held firm Linden Labs, as are the structure and the rules. It is not a democracy. It's a highly imaginative profit maximising benevolent dictatorship. It's got to be, since it has fiduciary obligations to its shareholders. There are clear divergences of interest between the users and the owner of the platform. How much [land](#) can Linden create and sell? How much money can Linden print?

The most profitable community is one which is [economically managed](#) rather than left alone. The owner would reduce competition among suppliers in favour of an oligopolistic structure, and would sell memberships in that oligopoly.

To conclude: Opportunities exist for specialised computer simulations and for advanced multiplayer video games. Virtual worlds, however, make a much wider claim. They want to be entire worlds of numerous activities. They want to be profitable simulations of the entire economy. And that is less likely to be successful. Virtual worlds are mostly consumption economies in which people spend money earned in a real world. They resemble more a [resort economy](#) based on entertainment, and such an economy requires a constant injection of outside dollars, and a costly ratcheting up of the thrill level to keep the relatively scarce visitors coming back. The commercial operators are likely to have the greatest incentives to make their islands more attractive, and this means that the virtual worlds will become increasingly over-commercialised, making them less attractive to many users. And this would also mean a costly rise in the required financial incentives to steer users to visit the virtual world.

These dynamics are less visible in early stages of a virtual world, where growth raises the value of created assets. However, once this growth slows down, as it inevitably must, and with competitive entry into various services and virtual worlds, their economics will follow the pattern of classic boom-bust cycles. The upward self-reinforcing growth of a virtual world can quickly be followed by a downward spiral.

Thus, it is not likely that competitive virtual world activities will be particularly profitable, outside of short-term unique products, and of the ownership and management of the world itself.

Many other Web 2.0 applications will exhibit similar fundamental characteristics and instability, once analysed in the required detail. After all, they share the elements of interactivity and community. This does not bode well for the Web 2.0 companies, unless they can establish not only significant market power, but also manage keeping fickle young users to stay loyal. This is unlikely. Hope springs eternal that new technology also means new economic principles, but it never does.

[Web 3.0, anyone?](#)

A Video is Worth a Thousand Words

1) Introduction:

Ginko Financial Bank Run: <http://www.youtube.com/watch?v=bqfBJOQoQzc>

Virtual Worlds Tour: <http://www.youtube.com/watch?v=Z7C6LAEQUGs>

Tutorial on Web 2.0: <http://www.youtube.com/watch?v=rNWTf3Gsnpc>

Roche, Edward M. "Crafting a Strategy for Virtual Worlds: Eight Questions to Ask." The Conference Board New York. August, 2007 No. 242: http://www.citi.columbia.edu/roche_-_virtual_worlds_eight_questions_to_ask.pdf

Grand Opening of the Swedish Embassy: <http://www.youtube.com/watch?v=mhR43Yt9Pcs>

U.S. Congress in Second Life: <http://youtube.com/watch?v=X6N-6lQw7BU>

2) Business Model #1: Marketing Real Products

The New Mercedes-Benz C-Class: <http://www.youtube.com/watch?v=MyqwxcoYKwo&mode=related&search=>

Coca-Cola Contest: <http://www.youtube.com/watch?v=wRjIVeATswQ>

Rose, Frank. "How Madison Avenue is Wasting Millions on a Deserted Second Life" Wired Magazine. July 24, 2007: http://www.wired.com/techbiz/media/magazine/15-08/ff_sheep

3) Business Model #2: Selling Virtual Products (V-Commerce)

Virtual Product Marketplace (SLexchange): <http://www.slexchange.com/index.php>

4) Business Model #3 : B2B Services to Virtual Operators

Virtual Architecture Blueprint: <http://www.youtube.com/watch?v=KruzH82Z2qQ&mode=related&search=>

Virtual Island Kit Demo:

http://www.dailymotion.com/relevance/search/second+life/video/x2934r_second-life-wave-and-island-kits-de_videogames

5) Business Model #4: New-Style Services

Virtual Litigation Over Sex Paraphernalia: http://www.youtube.com/watch?v=TJw1rhg_5do

Virtual Casinos with Real Money: <http://www.youtube.com/watch?v=i7jkro8zvDA&mode=related&search=>

Ohio University: <http://www.youtube.com/watch?v=aFuNFRie8wA>

Sales Training Demo:irate Customer: <http://www.youtube.com/watch?v=vbBaaj-z2f8>

Virtual Press Conference: Sun Microsystems: <http://www.youtube.com/watch?v=lmMeLo4Wz7o>

Market Research Consultancy: <http://www.youtube.com/watch?v=ryXB8VcCuNo>

6) Business Model #5: Media Content Distribution

U2 Virtual Concert: <http://www.youtube.com/watch?v=Mro9Qzv-k8>

World of Warcraft Snowball Fight: <http://www.youtube.com/watch?v=ovEjzKp6yXA>

Bantam Dell Publishing: Virtual Author Reading: <http://www.youtube.com/watch?v=tYonVhBqh1Q>

Grand Theft Auto: Murder Spree: http://www.youtube.com/watch?v=OveTk_6Ex5A

8) Business Model #6: Community Creation

The Virtual Birthday Party: <http://www.youtube.com/watch?v=wsfoGSh9J2Q>

9) Business Model #7: Owning the Virtual World

Claburn, Thomas. "Virtual Property Rights Are No Game." InformationWeek. December 16, 2006: <http://www.informationweek.com/news/showArticle.jhtml;jsessionid=Q22PKoON42CWUQSNDLPCKHSCJUNN:articleID=196604327>

Irwin, Mary Jane. "Virtual Economies: Second Life Land Bubble." Valley Wag. September 12, 2007:

<http://valleywag.com/tech/virtual-economies/second-life-land-bubble-299278.php>

Linden Labs Bans Virtual Casinos: Encounters Virtual Opposition:

<http://www.youtube.com/watch?v=ceGPSr19Qh8>

10) Conclusion

Sunrise Village Party: <http://www.youtube.com/watch?v=mNegVUsZwVo>

Eric Schmidt on Web 3.0: <http://youtube.com/watch?v=ToQJmmdw3bo>

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