Econ 30024, 2014 Semester1
Economics of Financial Markets

1. Subject information

   **Lecture time and location**
   Monday, 12pm -2pm
   Alan Gilbert, Theatre 2

   **Tutorial time and location**
   Monday 11am-12pm, Spot 2017
   Monday 2:15pm-3:15pm, 757 Swanston 222
   *** Participation contributes to 10% of your final mark!

   **Course coordinator**
   Kei Kawakami
   Email: keik@unimelb.edu.au
   *** Please include “Econ 30024” in the subject line when you send me an email about the course, so that I can respond to it in a timely fashion.
   Office hours: Monday, 4:15pm-6:15pm, Econ department 334

   **Tutor**
   Theo Josseff
   Email: tjosseff@student.unimelb.edu.au

   **Prerequisites**
   Intermediate Macro & Micro (ECON20001 & ECON20002)
   Introductory Econometrics or Quantitative Methods 2 (ECOM20001 or ECON20003)

   **Credit points:** 12.5
   **Level:** 3 (undergraduate)

2. Assessment

   60%: 2 hour final examination.
   15%: A mid-semester test. (April 14th)
   15%: Short assignments during the semester.
   10%: Participation in tutorials.

3. Textbook

Other references
*** Additional reading will be given as the course progresses.

4. Course outline

This course provides:
(i) An overview of economic principles governing financial markets.
(ii) Insights into theoretical, empirical and practical issues concerning the operation of financial markets.
(iii) An introduction to important applied work in the economic journal literature.
(iv) An opportunity to use quantitative skills to address the empirical issues in the economics of finance literature.

Upon successful completion of the course, students should:
(i) Understand how economic theory can be applied to financial markets.
(ii) Understand how economic theory imposes testable restrictions on financial data.
(iii) Be familiar with the established theoretical and empirical findings for financial markets.

Subject topics
1. Asset markets and asset prices.
2. Predictability of prices and market efficiency.
3. Decision making under uncertainty.
4. Portfolio selection: the mean-variance model.
5. The capital asset pricing model (CAPM).
6. The arbitrage pricing model (APT).
7. Empirical appraisal of CAPM and APT.
8. Present value relationships and price volatility.
10. Introduction to dynamic asset pricing.
Topic 1. Asset markets and asset prices
· The main types of capital markets.
· Fundamental principles of asset price determination.
· Arbitrage.
· Concepts of asset market efficiency.

**Required reading**: Economics of Financial Markets, Ch.1.

**Recommended reading**
Elton & Gruber, Ch.2 & 3.
Cuthbertson & Nitzsche, Ch.1.

**Supplementary reading**:

Topic 2. Predictability of Prices and Market Efficiency
· Random walks and martingales.
· Asset market efficiency and anomalies.
· Event studies.

**Required reading**: Economics of Financial Markets, Ch.3.

**Recommended reading**
Elton & Gruber, Ch.17
Cuthbertson & Nitzsche, Ch.3.

**Supplementary reading**

Topic 3. Decision-Making under Uncertainty
· Risk and uncertainty.
· State preference analysis.
· Expected utility hypothesis.
· Mean-variance analysis.

**Required reading**: Economics of Financial Markets, Ch.4.

**Recommended reading**
- Elton & Gruber, Ch.11
- Cuthbertson & Nitzsche, Ch.1.

**Topic 4. Portfolio Selection: Mean-Variance Model**
· The portfolio frontier with two risky assets.
· Inclusion of a riskless asset.
· Many risky assets.
· Portfolio separation theorems.
· Optimal portfolio selection: the mean-variance case.

**Required reading**: Economics of Financial Markets, Ch.5.

**Recommended reading**
- Elton & Gruber, Ch.4&5
- Cuthbertson & Nitzsche, Ch.5.

**Supplementary reading**
- Elton & Gruber, Ch.6
- Copeland & Weston, Ch.6.

**Topic 5. Capital Asset Pricing Model (CAPM)**
· Assumptions of the model and its relationship with portfolio selection.
· Implications of CAPM for individual assets.
· Portfolio diversification and the market portfolio.
· Extensions: no riskless asset, borrowing constraint, etc.

**Required reading**: Economics of Financial Markets, Ch.6.

**Recommended reading**
- Elton & Gruber, Ch.13&14.
- Cuthbertson & Nitzsche, Ch.5&7.

**Supplementary reading**
- Copeland & Weston, Ch.6.

**Topic 6. Arbitrage Pricing Theory (APT)**
· Arbitrage opportunities and their absence.
· Factor models of asset markets.
· Implications of the absence of arbitrage opportunities.
· Comparison with the CAPM.
**Required reading:** Economics of Financial Markets, Ch.7&8.

**Recommended reading**
- Elton & Gruber, Ch.16.
- Cuthbertson & Nitzsche, Ch.7.

**Supplementary reading**
- Copeland & Weston, Ch.6.

**Topic 7.** Empirical Appraisal of CAPM and APT

- Testing the CAPM and APT using data on asset prices.
- Methodological problems of testing asset pricing models.

**Required reading:** Economics of Financial Markets, Ch.9.

**Recommended reading:** Cuthbertson & Nitzsche, Ch.8.

**Supplementary reading**

**Topic 8.** Present Value Relationships and Price Variability

- Asset prices as Net Present Values.
- Models and empirical tests of asset price volatility.
- Extreme fluctuations in asset prices.

**Required reading:** Economics of Financial Markets, Ch.10.

**Recommended reading:** Cuthbertson & Nitzsche, Ch.10&17.

**Supplementary reading**
Topic 9.  Bond Prices and the Term Structure of Interest Rates

- Bond pricing, yields and yield curves.
- Theories of the term structure of interest rates.
- Empirical evidence on the term structure of interest rates.

**Required reading:** Economics of Financial Markets, Ch.12&13.
**Recommended reading:** Cuthbertson & Nitzsche, Ch.20-22.
**Supplementary reading**

Topic 10.  Introduction to Dynamic Asset Pricing

- Consumption-based asset pricing model.
- Empirical evidence and the equity premium puzzle.

**Required reading:** Economics of Financial Markets, Ch.11.
**Recommended reading:** Cuthbertson & Nitzsche, Ch.13&14.
**Supplementary reading**
5. Lecture schedule

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EFM: Economics of Financial Markets
EG: Elton and Gruber
CN: Cuthbertson and Nitzsche

Kei Kawakami
Updated March 10 2014