ECON30024
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Tutorial 1 (for Week 2)

1. Review Week 2 quiz questions.

2. Following quiz question (2), suppose that the current price of the asset is \$2. Calculate the expected rate of return and the variance of the rate of return on the asset.

3. Suppose the following exchange rates are observed:

$$£1 = \$1.50,\ ¥150 = £1,\ \$1 = ¥120.$$

   Suppose the foreign exchange markets are frictionless.

   (a) Is there an arbitrage strategy? If so, find it.

   (b) Do you think these exchange rates would persist? If not, what do you expect the exchange rates will change?

   (c) Now suppose financial frictions are present in the foreign exchange markets, for instance, the exchange of currencies is subject to different transaction costs for different pairs of currencies. Are your answers to (a) and (b) still valid?

   (d) Use this example to reflect upon quiz question (5).

   (e) Is this statement true? When market frictions are pervasive, the arbitrage principle cannot hold.

4. Discussion questions

   (a) The focus of this subject is to discuss some important theories of asset price/expected return determination and their applications.[1] Why does asset pricing matter?

   (b) Do you think the financial sector has grown too big relative to its contribution to the real economy?

[1] Asset pricing models such as the CAPM, APT, and NPV pricing rules are also in the core curriculum of Finance subjects.