



**Paper 2**

These documents were prepared for markers' reference. They should not be regarded as sets of model answers. Candidates and teachers who were not involved in the marking process are advised to interpret their contents with care.

The answers provided in the marking scheme are for reference only. They are not the only possible answers. Alternative answers are acceptable so long as they are well reasoned.

The examination emphasises the testing of the understanding of economic theories and the application of the knowledge of economic analysis to practical problems. Candidates are advised to study this document in conjunction with the examiner's comments on candidates' performance in this booklet.

For essay-type questions, candidates are expected to demonstrate an understanding of the question, an ability to deploy relevant knowledge of the subject in response to the questions, and to present their answers logically and coherently.

In questions asking for a specified number of reasons or examples etc. and a candidate gives more than the required number, the extra answers should not be marked. For instance, in a question asking candidates to provide two examples, and if a candidate gives three answers, only the first two should be marked.

The following symbols are used:

- / A single slash indicates an acceptable alternative within an answer.
- @ The number in front of the symbol indicates the marks for each point.
- max Maximum mark for the question/sub-question

**Section A**

1. (a) The opportunity cost will remain unchanged. It is because the height limitation only reduces the value of the reclaimed land but does not affect the highest valued option forgone. **Marks (2)**

(b) The government needs to spend extra money/resources to compete for the raw materials in the case of shortage so monetary/non-monetary cost will increase and the full cost will increase. **(3)**

2. (a) Statement A is a positive statement because it is refutable by fact. **Marks (2)**

(b) Equalising income: the districts are with lower average household income so this cash will help narrow the income gap. } @2  
Equalising opportunity: the subsidy on education will enhance the chance of the poor to get higher education without being hindered by their backgrounds. } max: 4

3. Examples: **Marks (1)**

- HK Airport Authority
  - Hong Kong Export Credit Insurance Corporation
  - any other relevant example
- [Mark the FIRST point only.]

Advantages: } @1  
- easier to get information about the general public from the government for decision-making  
- can provide stable service with a lower price  
- easier to get loan with the backup of the government  
- any other relevant point } max: 2  
[Mark the FIRST TWO points only.]

4. Getting vaccinated protects oneself as well as lowering the chance of others being infected by flu. Since the person receiving vaccination is not compensated by others (whose chances of being infected are reduced), there exists external benefit, with marginal social benefit exceeding marginal social cost. This implies that the number of people getting vaccinated is below the efficient level. Subsidy can increase the quantity of vaccination towards the efficient level and thus narrow the gap between marginal social benefit and marginal social cost.

**Marks**  
(4)

5. (a) Division of labour/ (Principle of) comparative advantage  
[Mark the FIRST point only.]

**Marks**  
(1)

Benefits:

- Finding the most suitable person for the job: the parents in both families can use their expertises in teaching their children so the children can learn both languages better.
- Specialisation and exchange: Mr Wong can specialise teaching English, i.e. the production in which his opportunities cost is lower, then exchange for his children learning Japanese from Mrs. Chan. The children can learn both languages better with a lower cost. (Similar argument applies to Mrs Chan in her teaching of Japanese as well.)
- any other relevant point

(2)

- (b) Economies of scale.  
[Mark the FIRST point only.]

(1)

Benefits:

- They can have more discounts when food ingredients are purchased in bulk which would reduce the average cost of producing the dinners.
- Cooking together can save the average cooking time and at the same time can have a larger variety of food choices.
- any other relevant point

(2)

6. (a) Increased (+1.7%).

**Marks**  
(1)

- (b) He would gain because when the actual inflation rate (1.7%) was lower than the expected inflation rate (2.3%), the actual real interest rate received (3.3%) was higher than the expected real interest rate (2.7%). OR the purchasing power of the interest received was higher than expected.<sup>1</sup>

(3)

- (c) Real wage rates increased because the increase in the nominal wage rate 6.2% was higher than the inflation rate 1.7%.

(3)

<sup>1</sup> The fact that Siu Keung was willing to lend money to Kitman in 2017 implies (by revealed preference) that they both expected gains from such borrowing and lending arrangement (known as intertemporal trade). The fact that the actual inflation rate (1.7%) turned out to be lower than expected (2.3%) merely implies that the *ex post* (actual) gain from intertemporal trade was bigger than the *ex ante* (expected) gain.

7. (a) Excess reserves = \$300 million – \$1000 million x 20% = \$100 million

**Marks**  
(1)

- (b) Old money supply = \$1000 million + \$200 million  
= \$1200 million

New money supply = (\$300 million + \$200 million) x 1/20% + \$0 million  
= \$2500 million

Maximum possible change in the money supply = \$2500 million – \$1200 million  
= \$1300 million

(4)

8. (a) (i) Yes.  
When Country B has the same resource as Country A, the output of cars would be 200 units which is higher than that of country A.

**Marks**  
(2)

- (ii) Yes.  
The opportunity cost of producing 1C in Country A = 1T  
The opportunity cost of producing 1C in Country B = 0.6T  
Country B has a comparative advantage in producing cars.

(3)

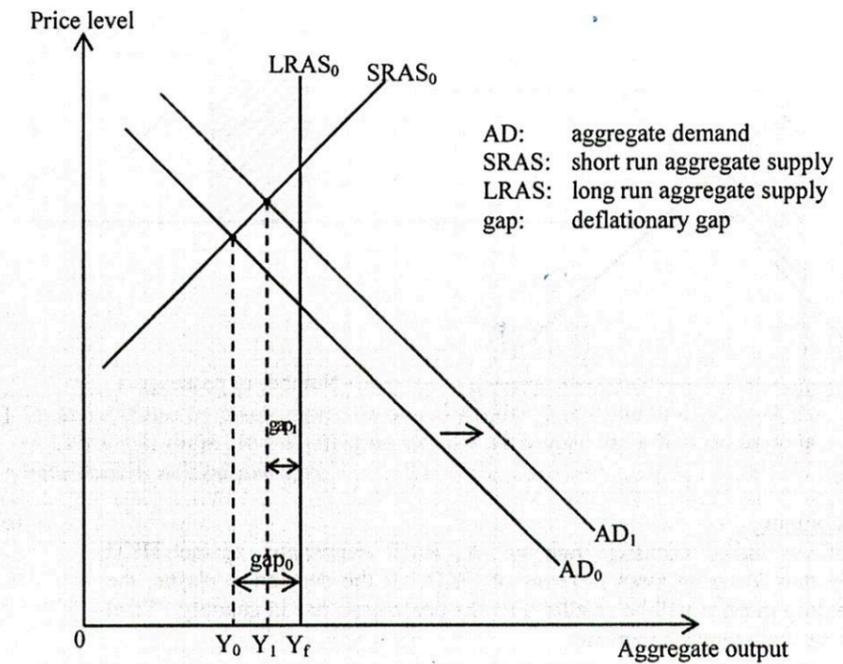
- (b) TOT: 1C=0.8T  
The per unit gain for the car-importing country (i.e., Country A) = 1T – 0.8T = 0.2T  
Its total gain from trade = 0.2T × 10 = 2T

(3)

**Section B**

9. (a) Public good. It is because the videos are non-rivalrous in consumption as people can concurrently watch the video without affecting one another. **Marks (3)**
- (b) Horizontal expansion. **(1)**
- Reasons:
- enlarge the market share
  - enjoy economies of scale
  - make use of the brand name
  - any other relevant point
- [Mark the FIRST TWO points only.] **@1 max: 2**
- (c) Advantage: Cost of measuring output of the employees can be saved.  
Disadvantage: Work incentive may not be high.  
[Mark the FIRST advantage and FIRST disadvantage only.] **(2)**
- (d) Advantage: Higher output will yield higher income.  
Disadvantage: Income may be unstable.  
[Mark the FIRST advantage and FIRST disadvantage only.] **(2)**

10. (a) It is a progressive tax because higher average tax rate is charged for tax payers with higher income. **Marks (2)**
- (b) Verbal elaboration: **(4)**  
The middle income group is charged a lower average tax rate, their disposable income rises, consumption and aggregate demand increase, narrowing the deflationary gap.
- Illustrate in the diagram:
- correct initial deflationary gap **(1)**
  - AD shift rightward<sup>2</sup> **(1)**
  - correct new Y with a smaller gap **(1)**



- (c) For: Pros of the monetary policy OR Cons of the fiscal policy **(2)**
- The monetary policy increases Y via investment which will help enhance present/future productivity (while the tax policy may not have such an effect).
  - The tax policy may worsen the fiscal balance of the government (while the monetary policy will not have such an effect).
  - any other relevant point
- Against: Pros of the fiscal policy OR Cons of the monetary policy **(2)**
- The tax policy may narrow the income gap (while the monetary policy won't have such an effect).
  - Bank loans and money supply may not increase even if there is a fall in the required reserve ratio (while the tax policy will not be affected by the action of commercial banks).
  - any other relevant point

<sup>2</sup> SRAS and / or LRAS may also shift to the right because of the increase in work incentive as a result of tax reduction. If we focus only on the short run effect of the policy, then the deflationary (output) gap should be narrowed.

11. (a) The launch of HSR will increase the geographical mobility of workers because the transportation network improves.

Marks  
(3)

(b) Verbal elaboration:

Fares are set above the market-clearing (or equilibrium) level. So marginal benefit of train service is larger than marginal cost.

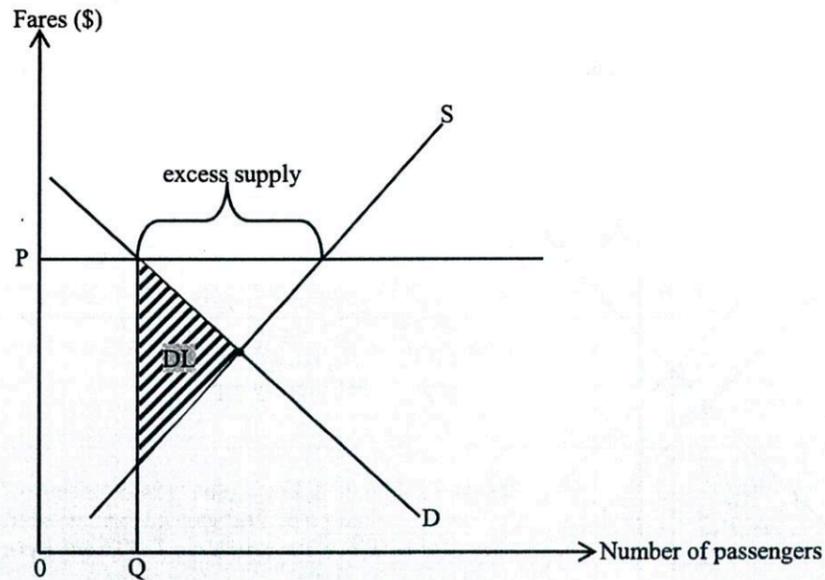
(2)

Illustrate in the diagram:

- correct position of P and Q
- correct position of deadweight loss (DL)

(1)

(1)



(c) Verbal elaboration:

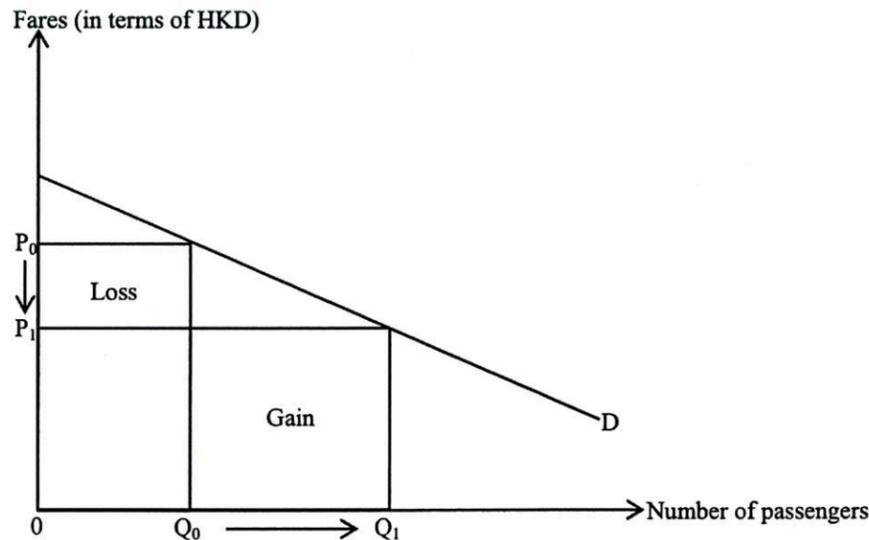
Because of the linked exchange rate system, RMB depreciates against HKD accordingly thus lowering fares in terms of HKD. If the demand is elastic, the percentage drop in price will be smaller than the percentage rise in quantity. Total ticket revenue will therefore increase.

(6)

Illustrate in the diagram:

- correct position of gain and loss
- gain > loss

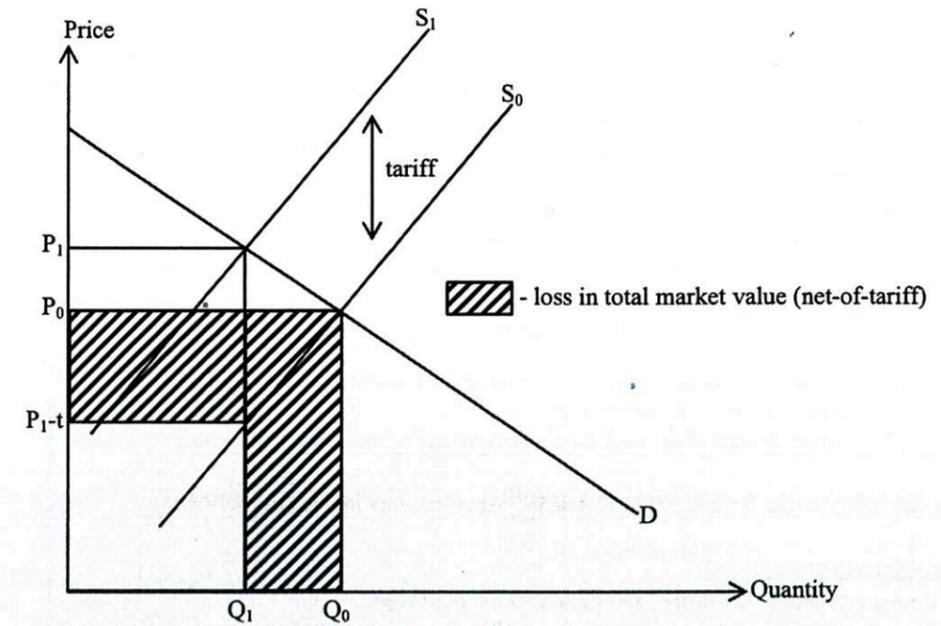
(2)



12. (a) (i) Illustrated in the diagram:

Marks  
(3)

- S shifts up
- Lower total market value (net-of-tariff)



(ii) China retaliates by charging tariffs on US goods. The value of exports of US to China will drop. If the effect on exports outweighs the effect on imports, trade deficits will be enlarged.<sup>3</sup>

(3)

(b) No. Hong Kong is a major re-exporter between US and China and some re-exported goods are subject to tariffs. So the value of these re-exports may drop and the total value of HK exports (which includes re-exports) may thus dropped as well.

(3)

<sup>3</sup> In the real world there are other factors that affect the trade balance: the demand elasticities of Chinese goods in US market and US's goods in China market, exchange rate policies of both countries and the reactions of the private firms in both countries, etc.

(c) Marks award for effective communication (EC: max 2 marks)

Marks	Performance
2	<ul style="list-style-type: none"> <li>● Support arguments with the source/data and appropriate economic theories.</li> <li>● Present relevant material.</li> <li>● Present well-organised and coherent answers without repetition of ideas.</li> <li>● Use language that expresses ideas clearly and fluently with appropriate use of words/terms/symbols.</li> </ul>
1	<ul style="list-style-type: none"> <li>● Present arguments with some support of the source/data and economic theories.</li> <li>● Present some irrelevant material.</li> <li>● Present answers in a less organised way with some repetition.</li> <li>● Use language that conveys a clear message with some inappropriate use of words/terms/symbols.</li> </ul>
0	<ul style="list-style-type: none"> <li>● Present arguments with no support of the source/data and economic theories.</li> <li>● Present material unrelated to the gist of the question.</li> <li>● Present inconsistent arguments.</li> <li>● Express limited ideas with inappropriate use of words/terms/symbols.</li> </ul>

The maximum marks for content is 11 marks. Answers may include the following:

Effects on aggregate output:

- Re-exports drops, AD drops, and aggregate output drops.
- The stock prices drop and people's wealth drops, consumption drops, and aggregate output drops.
- Some trading firms may consider moving away from Hong Kong to other countries in order to escape from the tariffs/ explore new markets. SRAS drops and aggregate output drops in the future.

Effects on tax revenue:

- Profits tax revenue will drop because some logistic/trading firms suffer and profits drop.
- Income tax revenue will drop as aggregate output and the average household income fall.
- Revenue from stamp duty may drop as the stock market crash may lower the volume of trade in the stock market.

Effects on other variables:

- Unemployment rate may increase as production drops and demand for labour is reduced as firms move away from Hong Kong. The unemployed population increases while the labour force remains unchanged.
- HKD may appreciate against RMB as Chinese government may lower the exchange rate of RMB to lessen the effect of the tariff on exported goods/ there may be large capital outflow from China.
- Government spendings may increase as the government may need to grant subsidy or loans to the affected firms and/or provide unemployment benefits to the jobless.

Section C

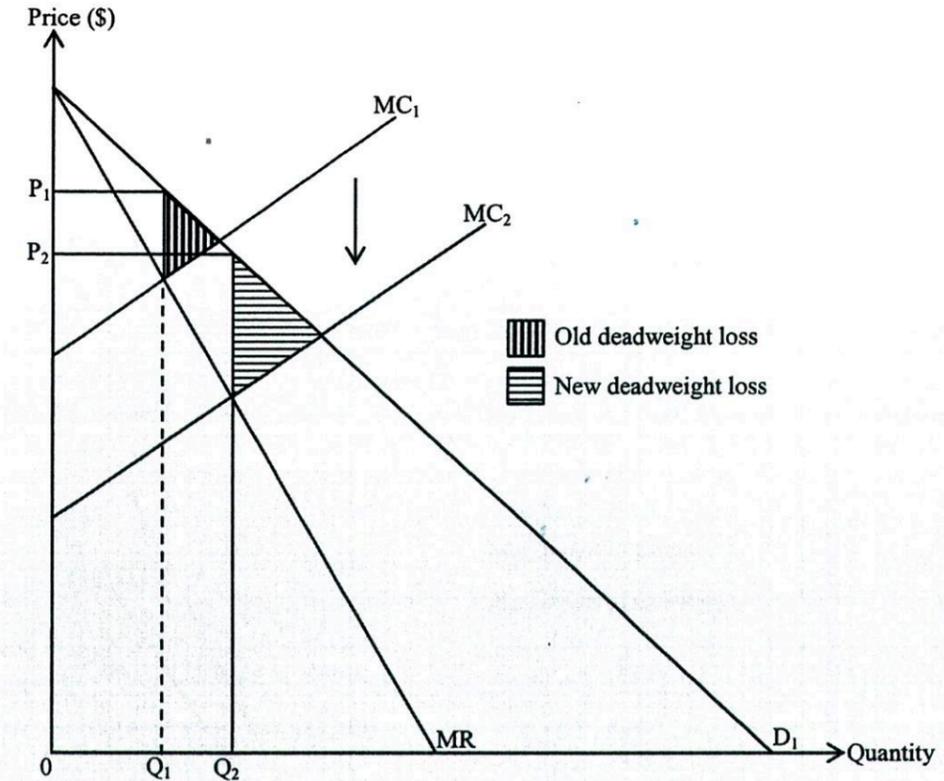
13. (a) Verbal elaboration:  
Marginal revenue = Marginal cost to determine profit maximising output. The firm will then set the price according to the demand curve.

Marks  
(1)

Illustrate in the diagram:

- correct position of marginal revenue curve
- correct position of  $Q_1$
- correct position of  $P_1$

(3)



- (b) (i) Illustrate in the diagram:  
- downward shift of marginal cost curve  
- correct position of  $P_2$  and  $Q_2$

(2)

- (ii) Verbal elaboration:  
Efficiency is worsened because the deadweight loss increases.<sup>4</sup>

(1)

Illustrate in the diagram:

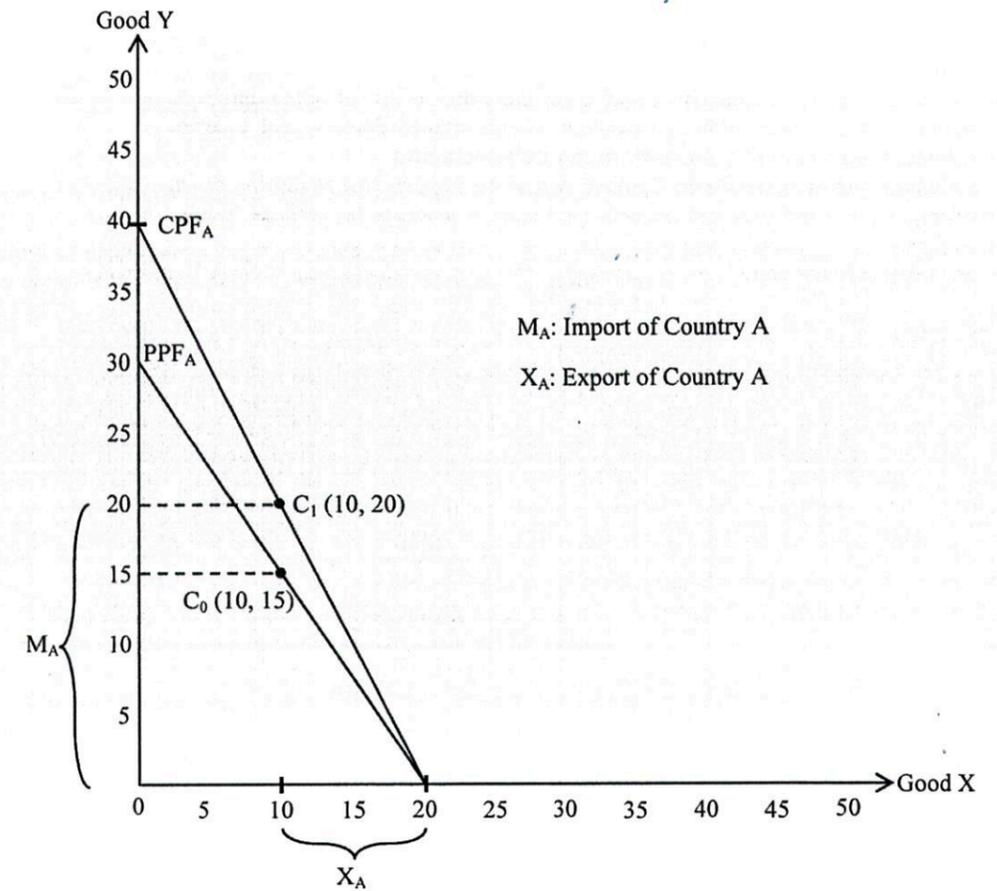
- correct position of the old deadweight loss
- correct position of the new deadweight loss

(2)

<sup>4</sup> It depends on the new position of the marginal cost curve. Candidates may answer "uncertain" if they can draw the old DL and new DL with similar size.

- (c) (i) Same products produced at same cost (e.g. smartphones) are charged different prices to different groups of consumers (e.g. students). **Marks (2)**
- (ii) Conditions: **(2)**
- Market is separable.
  - Elasticities of demand of two sub-markets are different.
- [Mark the FIRST TWO points only.]
- (d) Tie-in sale. **(3)**
- Harms to consumers:
- higher price
  - lack of choice
  - any other relevant points
- [Mark the FIRST TWO points only.]

14. (a) Good X. Because the opportunity cost of producing  $1X = 1.5Y < \text{world price } (=2Y)$ . **Marks (2)**
- (b) Illustrate in the diagram: **(5)**
- correct position of consumption point before trade  $C_0(10, 15)$
  - correct position of production point after trade  $P_1(20, 0)$
  - correct position of CPF after trade
  - correct position of consumption point after trade  $C_1(10, 20)$ <sup>5</sup>
- Verbal elaboration:  
Gain from trade = 5 units of Y
- (c) Illustrate in the diagram: **(2)**
- correct position of  $X_A$
  - correct position of  $M_A$



<sup>5</sup> Instead of indicating all the before-trade and after-trade production and consumption points in the diagram to find the gain from trade, candidates may also calculate the gain using formula.

- |  |              |
|--|--------------|
| (d) No. If the world price of Good X falls such that it is lower than the domestic opportunity cost (i.e., $1X < 1.5Y$ ), Country A will no longer have a comparative advantage in producing Good X.   | Marks<br>(3) |
| (e) <u>Reasons:</u><br>- Closing the door to those foreign workers who possess better knowledge and/or skills than domestic workers would lower the average level of human capital in Country A (and may even reduce its investment in human capital), and thus slow down its output growth.<br>- Closing the door to foreign trade would eliminate possibilities of importation of better-quality capital (machines and equipment) and superior production technology from foreign countries, and thus create negative effects on technological improvement and output growth in Country A.<br>- Loss of foreign funding in support of research and development in Country A, thus lowering its rate of technical progress.<br>- any other relevant point | (2)          |
| (f) <u>Reasons:</u><br>- Health of citizens in Country A may deteriorate due to loss of opportunities to import new and more effective medicine, better-trained doctors, and superior medical equipment and technology from foreign countries.<br>- Average level of education in Country A may be lowered due to closing down of international schools and departure of foreign teachers (as well as foreign students).<br>- any other relevant point   | (2)          |

## Candidates' Performance

### Paper 1

Candidates' overall performance was good. The mean score of this paper was 26 out of 45. The following questions deserve special attention.

Q.2 Which of the following statements are related to the problem of 'for whom to produce'?

- (1) Only the elderly and eligible persons with disabilities can enjoy a concessionary fare of \$2 per trip under the Public Transport Fare Concession Scheme.
- (2) Public rental housing (PRH) households whose family income exceeds 5 times the PRH income limits should vacate their PRH flats.
- (3) The e-Sports & Music Festival moved from Hong Kong Convention and Exhibition Centre to Hong Kong Coliseum to house more fans from all over the world.

- |                      |       |
|----------------------|-------|
| *A. (1) and (2) only | (45%) |
| B. (1) and (3) only  | (20%) |
| C. (2) and (3) only  | (2%)  |
| D. (1), (2) and (3)  | (33%) |

The question aims at testing candidates' understanding about the problem of 'for whom to produce'. Statement 3 is the major distractor. As the target audience of the e-Sports & Music Festival (i.e., fans from all over the world) remains unchanged, the change of venue in order to accommodate more fans is not related to the problem of 'for whom to produce'. Option D (as well as options B and C) is thus incorrect.

Q.9 A Hong Kong travel company offers package tours to Japan. It invested in building a hotel, which provides accommodation services to its tour members visiting Japan.

Which of the following is most likely the motive behind the expansion?

- |  |       |
|--|-------|
| A. to increase the market share              | (10%) |
| *B. to secure the supply of factor inputs    | (31%) |
| C. to ensure a market outlet of its services | (54%) |
| D. to reduce competition                     | (5%)  |

Most candidates were able to rule out Options A and D, as they recognised the input-output relation between hotel services and package tours. But many of them mistook Option C for the key, which would have been correct if a hotel expanded its business to package tours, but not the other way round (as in the case provided in the question). By building a hotel of its own, the travel company could make sure that there would be enough hotel rooms (which can be viewed as a factor input) for their package tours.