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**ECONOMICS PAPER 2**  
**Question-Answer Book**

10:15 am – 12:30 pm (2 hours 15 minutes)

This paper must be answered in English

**INSTRUCTIONS**

- (1) After the announcement of the start of the examination, you should first write your Candidate Number in the space provided on Page 1 and stick barcode labels in the spaces provided on Pages 1, 3, 5, 7, 9 and 11.
- (2) This paper consists of three sections, A, B and C. Answer ALL questions in sections A and B. Attempt any ONE question in section C.
- (3) Write your answers in the spaces provided in this Question-Answer Book. Do not write in the margins. Answers written in the margins will not be marked.
- (4) Supplementary answer sheets will be supplied on request. Write your candidate number, mark the question number box and stick a barcode label on each sheet, and fasten them with string INSIDE this book.
- (5) No extra time will be given to candidates for sticking on the barcode labels or filling in the question number boxes after the 'Time is up' announcement.



**Section A (50 marks)**

1. Although air ticket fares and hotel rates are usually higher during holiday periods, many people still travel abroad. Explain, in terms of opportunity cost, why it is *not necessarily* more expensive for travellers to travel abroad during holiday periods than non-holiday periods. (3 marks)

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2. Last year, Peter operated a sole proprietorship. Recently he invited Paul and Mary to form a partnership to expand the business to other markets.

(a) Suggest TWO reasons why Peter switched his firm's form of business ownership for expansion. (2 marks)

(b) Mary has invested in the firm but would not take part in its management. To what type of factor of production does Mary belong? Explain your answer. (2 marks)

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3. Shenzhen has become China's 'Silicon Valley'. The headquarters of many high technology firms such as Tencent (騰訊), Huawei (華為) and BYD (比亞迪) are located there. Explain **TWO** external economies of scale high technology firms may enjoy in Shenzhen. (4 marks)
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4. Apart from the difference in education level, explain **TWO** factors that may lead to income inequality. (4 marks)

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5. During peak flu seasons, there is not enough medical staff in public hospitals in Hong Kong.

- (a) An economist stated, 'Even if the government sharply increases the wage rates of the medical staff, it is still difficult to relieve the problem.' Justify his statement using the concept of elasticity of supply / demand. (3 marks)

(b) In order to relieve the pressure of the medical staff, the government plans to recruit retired medical staff to re-join the public hospitals. Explain how the measure would affect the unemployment rate in Hong Kong. (4 marks)

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6. The government proposes the following changes in the profits tax system.

Profit	Existing system	New two-tier system
On the first \$2 000 000		8.25%
Remainder	16.5%	16.5%

- (a) Would the above changes in tax system *necessarily* result in a drop in profits tax revenue? Explain. (4 marks)
- (b) Evaluate the above changes in the tax system in terms of ONE principle of taxation put forward by Adam Smith. (2 marks)

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7. (a) The following is the balance sheet of a banking system.

Assets (\$ million)		Liabilities (\$ million)	
Reserves	500	Deposits	2 000
Loans	1 500		

Initially the banks held \$100 million excess reserves and the public held \$100 million cash. Suppose the central bank buys \$40 million worth of government bonds from the public.

- (i) Calculate the new monetary base. Show your workings. (2 marks)
- (ii) State **TWO** assumptions under which the actual change in money supply would equal the maximum possible change in money supply. (2 marks)
- (iii) Calculate the maximum possible change in money supply. Show your workings. (4 marks)
- (b) Based on the quantity theory of money, predict the effect of an open market purchase of government bonds by the central bank on the price level. State the assumption(s) needed to reach your conclusion. (4 marks)

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8. Suppose the labour requirement for the production of toys and clothing in China and Japan is as follows:

	1 unit of toys	1 unit of clothing
China	10 man-hours	2 man-hours
Japan	8 man-hours	4 man-hours

- (a) Calculate the opportunity costs of producing one unit of toys for China and Japan respectively. (2 marks)
- (b) State the principle of comparative advantage. According to this principle, explain which country would export toys. (3 marks)
- (c) Suppose the transportation cost per unit of toys traded is 0.1 units of clothing and has to be shared equally by both countries. Find the range of terms of trade over which exchange between both countries is mutually beneficial. (2 marks)

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9. The Express Rail Link (XRL) project (Hong Kong Section) is expected to be completed in 2018. It will shorten the estimated journey time between Hong Kong and various Mainland cities. Below are some opinions on the XRL project.

Government officials

With better infrastructure, the overall economic development of Hong Kong will be enhanced.

Small medium enterprise owners

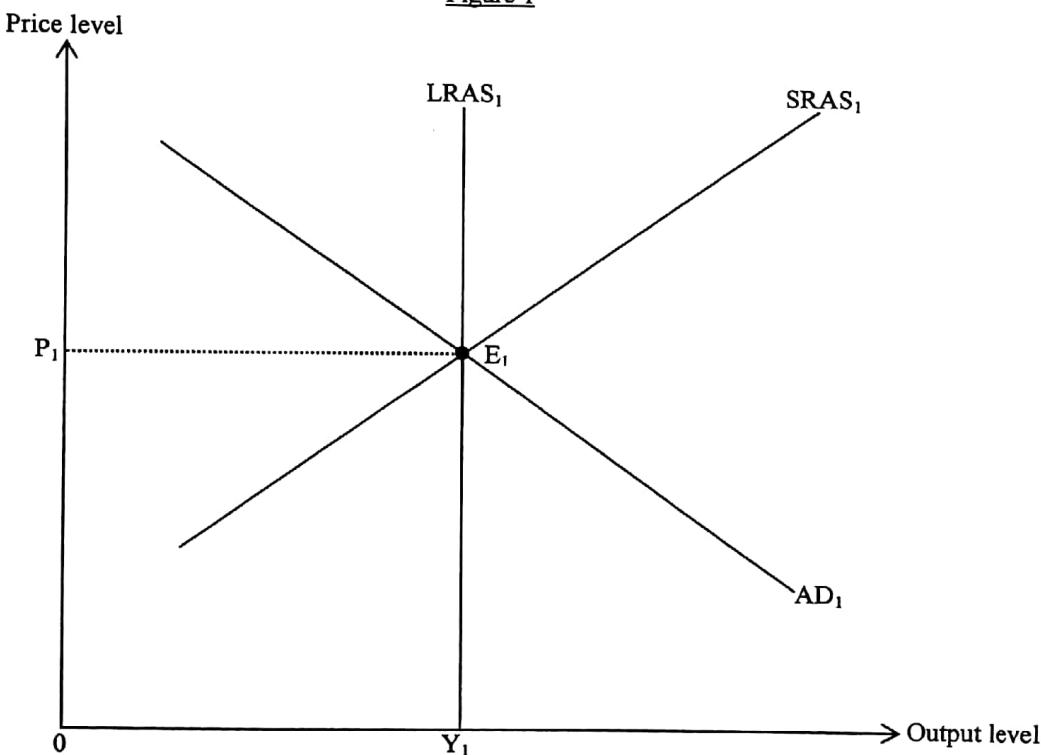
We expect that the XRL could bring more Mainland travellers to Hong Kong.

Suppose the Hong Kong economy operates at  $E_1$ . With reference to the above opinions, show why the price level of Hong Kong may rise in the long run after the completion of XRL project in Figure 1. (3 marks)

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Figure 1



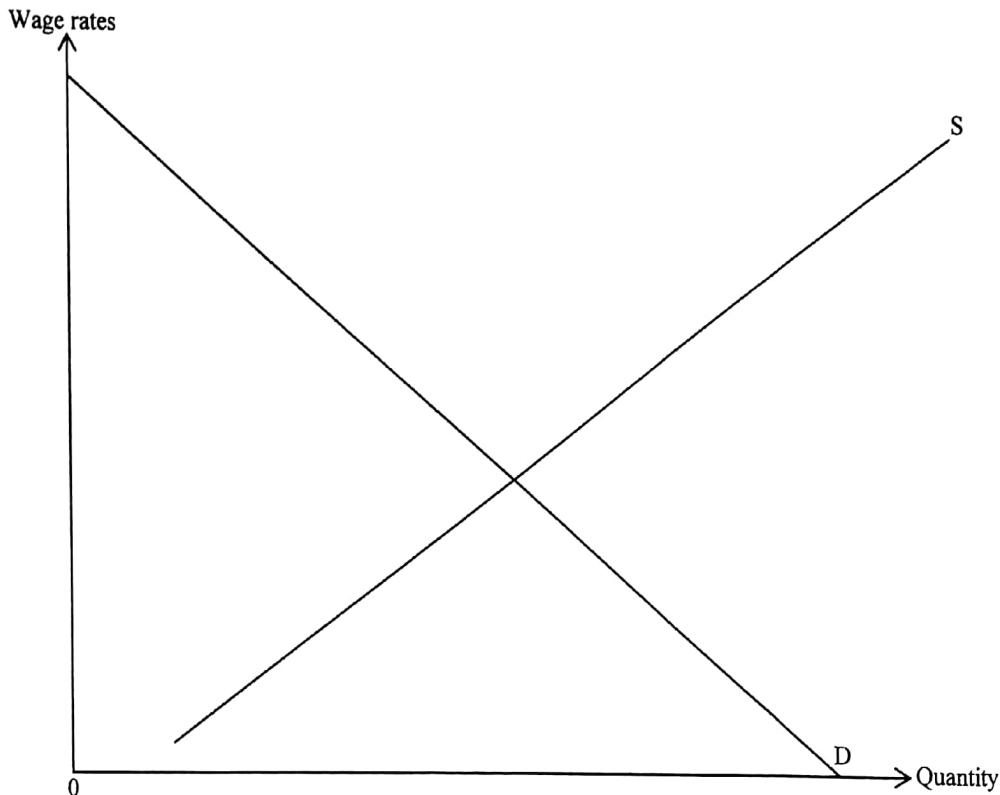
**END OF SECTION A**

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**Section B (54 marks)**

10. Foreign domestic helpers are paid with a minimum wage at HK\$4 410 per month for a two-year contractual period in Hong Kong.
- Explain why foreign domestic helpers are paid by a monthly salary instead of a piece rate. (2 marks)
  - Who, the employers or the foreign domestic helpers, will suffer a loss if there is an unexpected inflation in the contractual period? Explain. (2 marks)
  - Suppose the minimum wage in the market of foreign domestic helpers in Hong Kong is effective. With the aid of Figure 2, explain how it may result in economic inefficiency. (4 marks)

Figure 2: Foreign Domestic Helpers in Hong Kong



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It is reported that the Mainland market is about to open its doors to maids from the Philippines, offering them a salary several times higher than the minimum wage for foreign domestic helpers in Hong Kong.

- Some employers in Hong Kong claimed, 'Even if we offer higher wages to foreign domestic helpers, there will still be insufficient foreign domestic helpers in Hong Kong after the opening of the Mainland market to maids from the Philippines.' With the aid of Figure 2, explain why the above claim may be correct. (6 marks)
- Other than insufficient foreign domestic helpers, suggest ONE phenomenon that may be observed in the market of foreign domestic helpers in Hong Kong after the opening of the Mainland market to maids from the Philippines. (1 mark)

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11. To develop nuclear weapons and increase the military power, Country Z has raised the proportion of government spending on national defence from 10% to 20%. All males aged from 20 - 25 are also required to join the military force for 2 years.

In response to the increasing military threat from Country Z, the United Nations has passed a bill to embargo most of the goods exporting from Country Z.

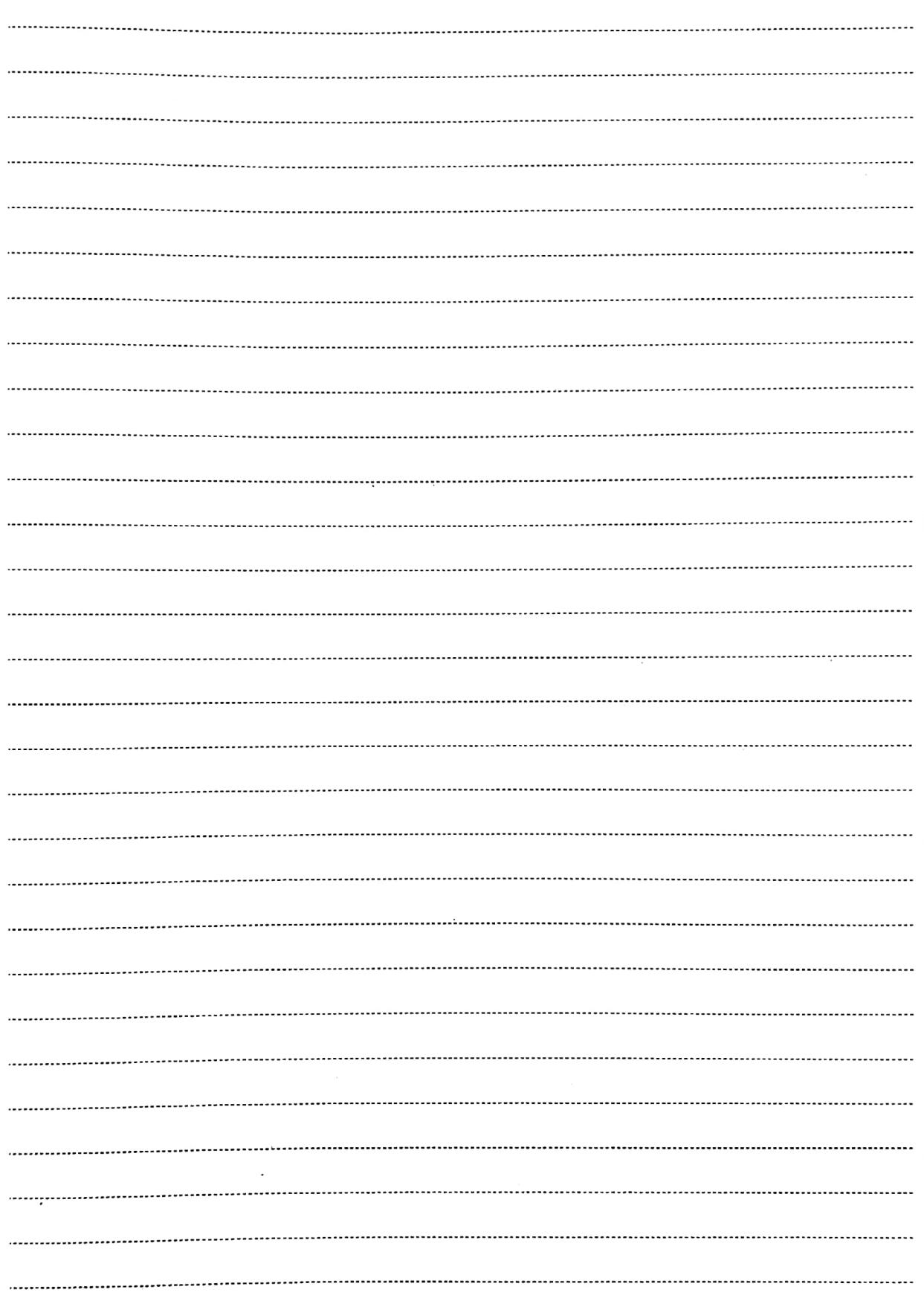
Analyse the effects of the above situation on Country Z's:

- general living standard,
  - aggregate output in the short run, and
  - balance of payment.

(10 marks)

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12. Tourism is one of the 'pillar industries' in Hong Kong.

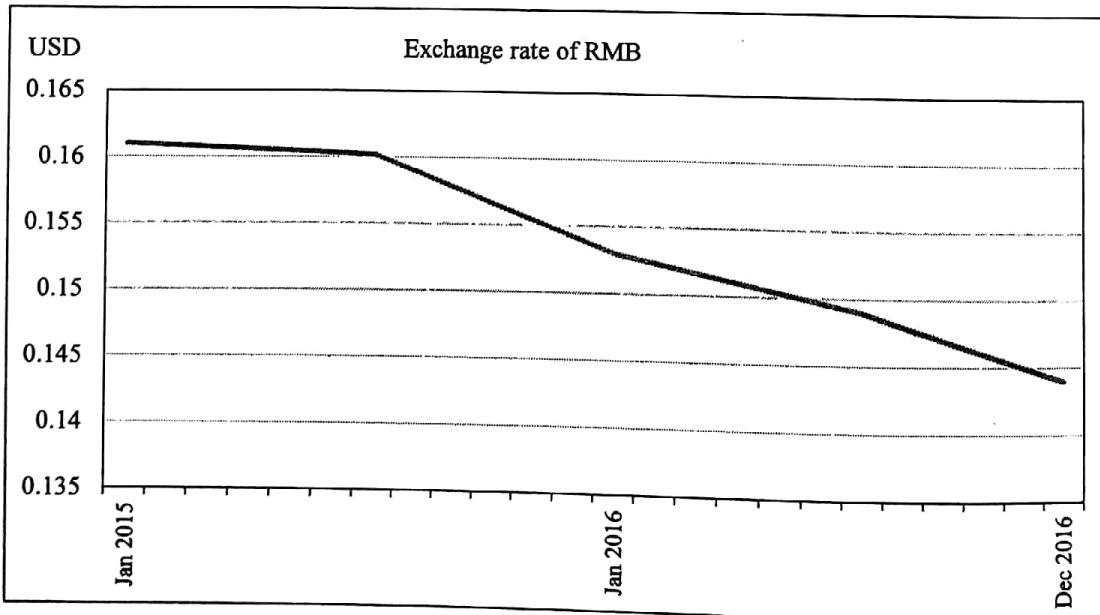
### Source 1: search result from a hotel booking website

<b>Hotel A</b> Tsim Sha Tsui East, Kowloon	☆ ☆ ☆ ☆ ☆  30 square metres 2 Twin Beds	Free cancellation	<b>Book now!</b> HK\$2100 OR RMB¥1750
<b>Hotel B</b> Tsim Sha Tsui East, Kowloon	☆ ☆ ☆ ☆ ☆  32 square metres 2 Twin Beds Free WIFI	Non-refundable	<b>Book now!</b> HK\$2040 OR RMB¥1700

Source 2: statistical data about tourism in Hong Kong in 2016

	2016	Compared with 2015 (%)
Mainland visitors	42.8 million	-6.7%
Total visitors	56.65 million	-4.5%
Total tourism expenditure associated to inbound tourism	HK\$296.2 billion	-10.1%

Source 3: exchange rate of the Renminbi (RMB) to the US dollar (USD) between 2015 and 2016



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- (a) With reference to Source 1, give **TWO** reasons to explain why the market structure of Hong Kong's hotel industry is **NOT** perfectly competitive. (4 marks)
- (b) Which **TWO** functions of money does the Renminbi perform in Source 1? Explain. (4 marks)
- (c) With reference to Source 2, to which component of Hong Kong's GDP does the 'total tourism expenditure associated to inbound tourism' belong? (1 mark)
- (d) A reporter stated, 'The change in the exchange rate of the Renminbi to the US dollar was a major factor contributing to the change of the total tourism expenditure associated to inbound tourism.' Based on Sources 2 and 3, justify his statement. (6 marks)

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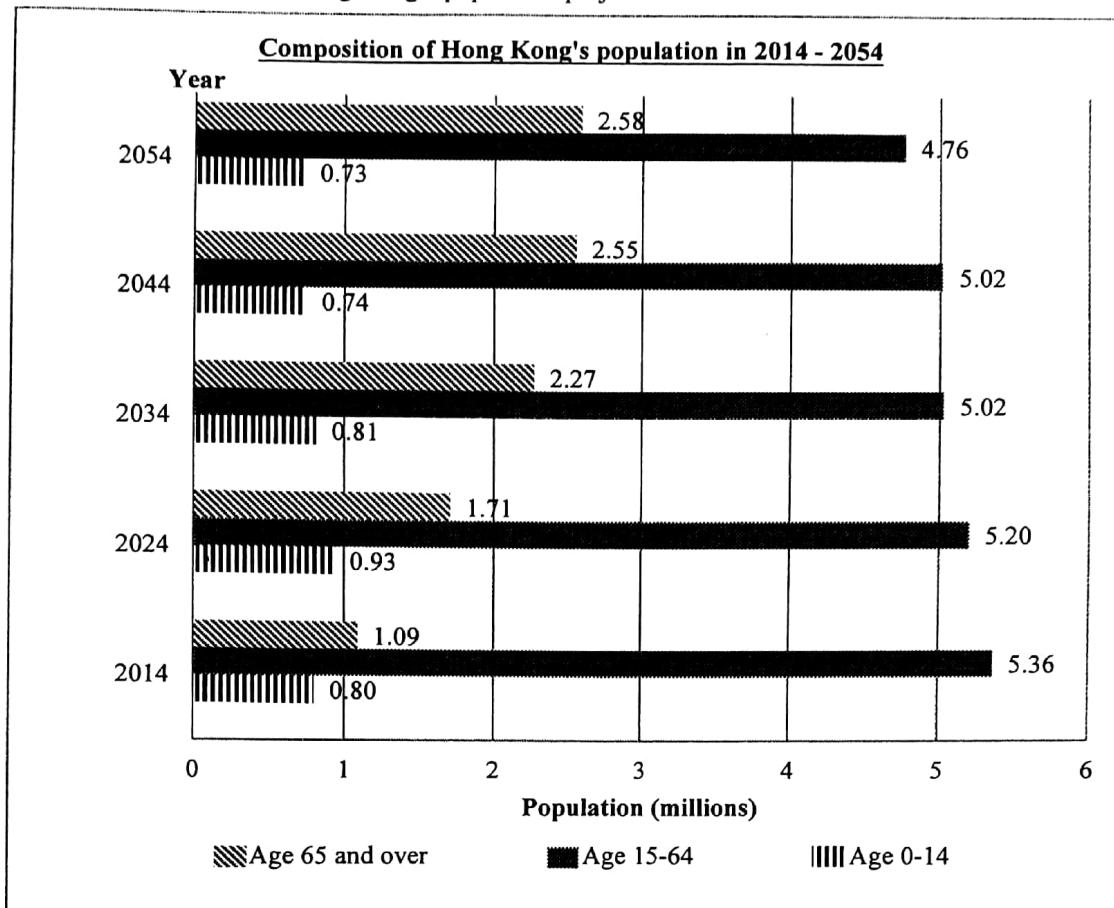
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13. The source below shows Hong Kong's population projection.



- (a) With reference to the above source, briefly discuss the possible effects of the change in composition of population on
- (i) potential output and
  - (ii) fiscal balance
- in the future. (5 marks)
- (b) In view of the population projection in Hong Kong, politicians suggest the following measures:
- (i) providing subsidy for firms to improve production technology
  - (ii) importing more workers
- Analyse how each of the above two measures affects average labour productivity. (5 marks)
- (c) Susan is a local S6 graduate and is considering enrolling a programme in either primary education or nursing in Hong Kong. If future income is her major concern, which programme would you recommend to her? Explain your choice with reference to the above source. (4 marks)
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**Section C (16 marks)** Answer any **ONE** question.

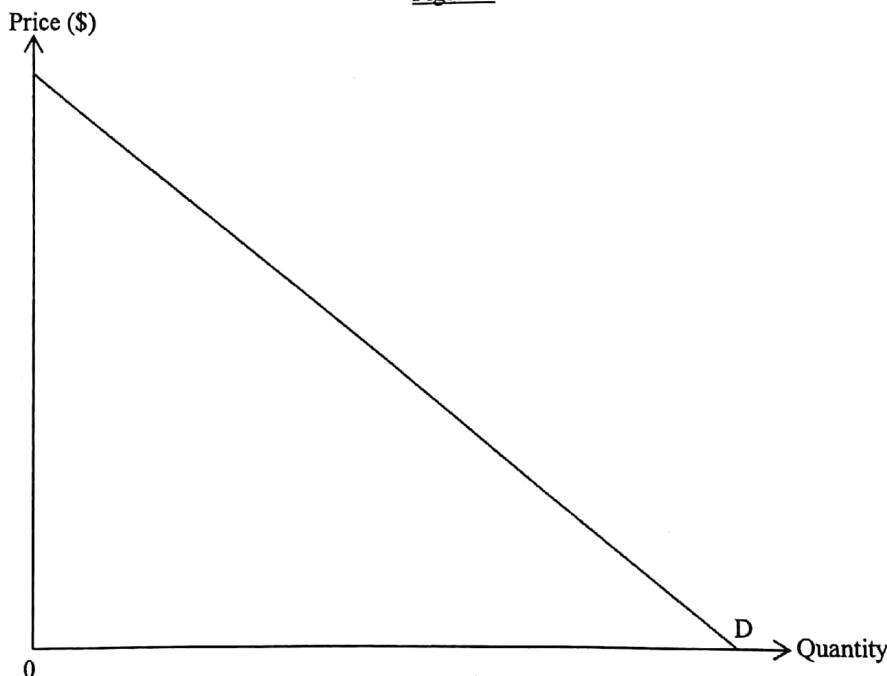
14. The petrol market in Hong Kong is dominated by five oil companies, namely Esso, Shell, Caltex, Sinopec and PetroChina.

Source: adapted from a report by Hong Kong Competition Commission

Same prices are often set across all petrol filling stations even though the stations are owned by different oil companies. Also only the most expensive type of petrol, '98 RON', is sold in the petrol market while other cheaper types of petrol with lower RON are unavailable in Hong Kong.

- (a) Name **ONE** anti-competitive behaviour that may be found in the above source. State **TWO** ways such behaviour may harm consumers. (3 marks)
- (b) Suggest **ONE** alternative reason to explain the behaviour of the oil companies in the source instead of accusing them of practising anti-competitive behaviour. (2 marks)

Figure 3



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Figure 3 shows the demand curve faced by a franchised bus company in Hong Kong. For simplicity, suppose the cost of fuel is the only cost of production and the company adopts uniform pricing.

- (c) Indicate the profit maximising output level as  $Q_M$  and price as  $P_M$  in Figure 3. (3 marks)

Suppose all the oil companies increase the price of fuel sharply.

- (d) Indicate the new price and quantity transacted as  $P_2$  and  $Q_2$  respectively in Figure 3. Indicate the deadweight loss in Figure 3 after the rise in fuel price. (3 marks)

- (e) Case 1: The bus company charges the elderly aged 65 or above \$2 per trip.  
Case 2: The bus company offers return discount concessions for all passengers.

Does each of the above two cases constitute price discrimination? Explain. (5 marks)

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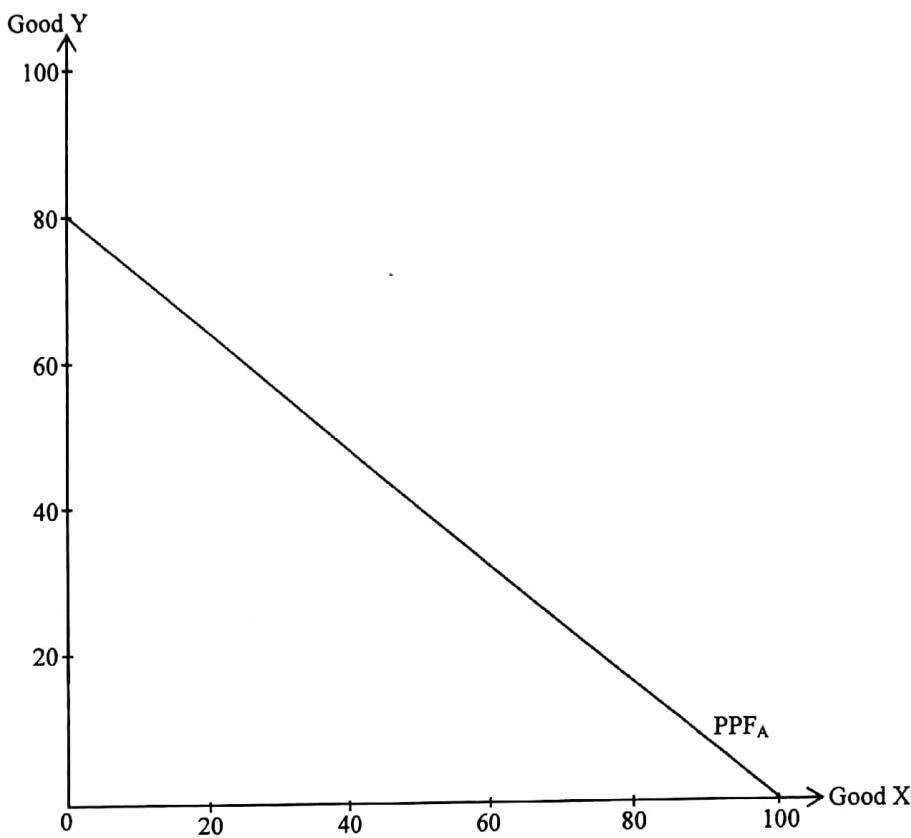
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15. Figure 4 shows the production possibility frontier (PPF<sub>A</sub>) of Country A.

Figure 4



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Both Country A and its trading partner, Country B, produce Good X and Good Y. Country A has 50 units of resources whereas Country B has 30 units of resources. Country B requires 1 unit of resources to produce 1 unit of Good X and 0.5 units of resources to produce 1 unit of Good Y.

- (a) Draw the production possibility frontier of Country B (PPF<sub>B</sub>) in Figure 4. (1 mark)
- (b) Explain which country has an absolute advantage in producing Good X. (3 marks)
- (c) The two countries trade with each other and the terms of trade is 1X = 1Y. Also, Country B consumes equal amount of Good X and Good Y after trade. In Figure 4, indicate
- the production point (P<sub>B</sub>) of Country B after specialisation, (1 mark)
  - the consumption possibility frontier (CPF<sub>B</sub>) and consumption point (C<sub>B</sub>) of Country B after trade and (2 marks)
  - the consumption possibility frontier (CPF<sub>A</sub>), the volume of import and the volume of export of Country A. (3 marks)
- (d) Explain whether the following policies would result in an increase in a country's Human Development Index (HDI).
- The government closes down environmentally harmful power plants and factories. (3 marks)
  - The government grants citizenship to all illegal immigrants so that they can stay and work in the country legally. (3 marks)

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**END OF PAPER**

Sources of materials used in this paper will be acknowledged in the booklet *HKDSE Question Papers* published by the Hong Kong Examinations and Assessment Authority at a later stage.

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