Economics Express Educational School

Hong Kong Advanced Level Mock Examination

AL Economics Paper 2

Section A

1. B	6. D	11. B	16. D	21. D	26. D
2. C	7. A	12. C	17. B	22. C	27. C
3. C	8. C	13. C	18. B	23. B	28. D
4. A	9. C	14. D	19. C	24. C	29. D
5. D	10. B	15. A	20. A	25. A	30. A

Section B

1. (a) S: Both of them are expenditure of the public sector.

D: Government consumption belongs to recurrent expenditure, government investment belongs to capital expenditure.

(b) S: Both of them measure the amount of money which is available in the economy.

D: M_0 = cash in public + reserve

M_1 = cash in public + demand deposit

(c) S: Both of them describe the change in the general price level.

D: Disinflation = the rate of increase in the general price is decreasing.

Deflation = a persistent decrease in the general price level.

(d) S: Both implies that some people within the labor force are having no job.

D: Structural unemployment is due to structural transformation.

Cyclical unemployment is due to economic recession.

(e) S: Both of them measure the value of foreign currency in terms of domestic currency.

D: Market exchange rate = the exchange rate at which the foreign currency and domestic currency are exchanged.

Purchasing power parity exchange rate = the exchange rate at which the purchasing power of foreign currency and domestic currency are the same.

3. (a) Real investment is a function of real interest rate, it is because investor only makes an investment decision when it can increase his/her purchasing power.

(b) Money demand is a function of nominal interest rate. It is because when a person holds a certain amount of money, he/she forgoes the option of buying bonds.

(c) Nominal interest rate = real interest rate + anticipated inflation rate
As price level is assumed to be constant in IS-LM model, the Y-axis can either be real or nominal.

4. (a) 1. Existing tax-payer;
2. People who fall into the tax net after the reduction of tax allowance.

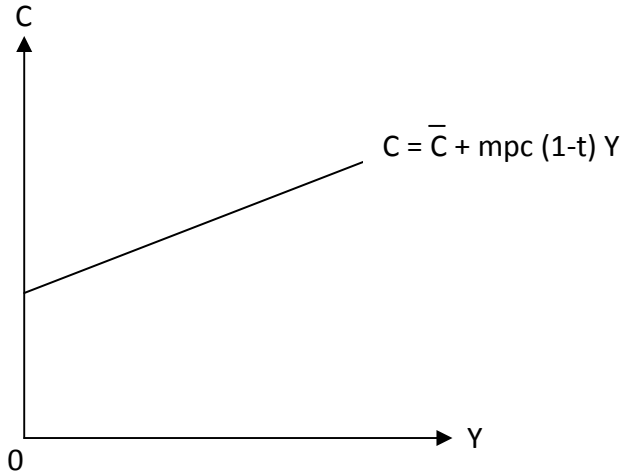
(b) Holders of monetary assets

(c) Future generations

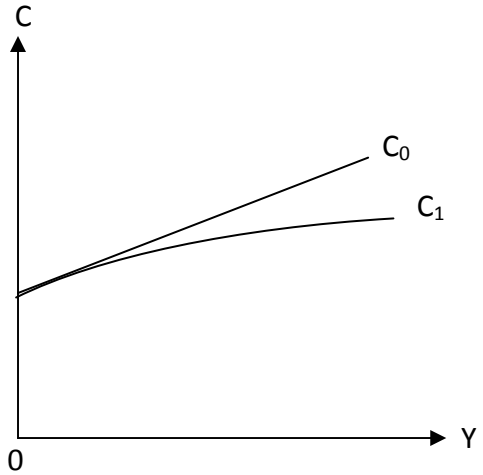
Section C

5. (a) C = C* + mpc(1-t)Y

(b)



(c)



(d) As $k = \frac{1}{[1-c(1-t)]}$, the value of the income multiplier gets smaller when private investment increases. Thus, the fluctuation of national income becomes smaller.

(e) The fluctuation of national income will even be smaller.

(f) Advantage: reduce income fluctuation, reduce income gap.
Disadvantage: reduce the effectiveness of discretionary policy, disincentive effects.

6. (a) 300

(b) Y = 2700, r = 0.15

(c) National income increases by 250;
The value of government expenditure multiplier is 2.5.

The value of the government expenditure multiplier will be larger when,

1) Marginal propensity to consume is large (or the value of marginal propensity to save is small);
2) Interest elasticity of investment is small;
3) Income elasticity of money demand is small;
4) Interest elasticity of money demand is large.

(d) national income increases by 200;
The value of government expenditure multiplier is 2

The value of the government expenditure multiplier will be larger when,

1) Marginal propensity to consume is large (or the value of marginal propensity to save is small);
2) Interest elasticity of investment is large;
3) Income elasticity of money demand is small.

7. (a) Suppose the interest rate of US rises relative to HK, the demand for the US assets and its currency rises, resulting in an appreciation of the US dollar against the HK dollar, causing discrepancy between the market rate and the linked rates. Then, HK's banks redeem their HK dollar from the Exchange Fund to get back the US dollar, which lead to a contraction in the money supply of HK and the local interest rate is driven up. In a nutshell, the interest rate of HK is closely aligned with that of US.

(b) The decrease in interest rate would lead to a depreciation for US dollar. If the sum of elasticity demand for exports and elasticity of demand for import is larger than 1, the balance of trade of US will improve.

(c) Under the linked exchange rate system, HK dollar depreciates against other currency. Based on the law of one price, the price level of HK increases.

(d) Under the new arrangement of linked exchange rate, the exchange rate for US1 ranges from HK7.75 to HK7.85. As a result, there is no need for HK interest rate to align with that of US.