PAPER 2 SUGGESTED ANSWERS

The following answers are for reference only. Alternative answers are also acceptable so long as they are well reasoned.

Section A — Marks

1. No. It is because more of the statistics are preferred. People are willing to pay a cost for viewing the statistics. The provision of the statistics incurs opportunity cost. — 3

2. Any two reasons as follows: — 2@, max: 4
   - differences in human capital: well educated people may earn a higher income.
   - discrimination: people of certain gender / race may earn a lower income because of gender / racial discrimination.
   - any other possible reasons

3. The law states that when variable factors are added continuously to fixed factors, holding technology constant, the marginal product will eventually decrease. — 3

Labour (Units)	3	4	5
Marginal Product (Units)	600	300	200

OR :
Marginal product of labour falls from 600 units to 300 units when labour increases from 3 units to 4 units.

∴ The data illustrate the law of diminishing marginal returns. — 3

4. (a) With more free time, customers will have a lower time cost in consuming services provided by karaoke lounges. The quantity demanded of the services will increase at each level of the market price, i.e. the demand for the services will increase. The market price of the services will increase as a result of the increase in demand. — 4

   (b) Not necessarily. The cost to consumers of the services includes the market price of the services and their time cost. With a higher market price and a lower time cost, the fact that the quantity demanded of the services is higher on holidays implies the full cost to consumers must have fallen. — 5

5. (a) The required reserve ratio = \$(225/1 500) = 0.15 — 1

   (b) The required reserve after withdrawal = \$1 200 x 0.15 = \$180. There will be an excess reserve of \$20. — 3

6. (a) (i) Nominal interest rate = real interest rate + expected inflation rate — 2

   (ii) The nominal interest rate would be lower than the real interest rate if the expected inflation rate is negative. — 2

   (b) The nominal interest rate is the return to holding interest bearing assets. Holding money forgoes the option of holding interest bearing assets, and the cost of doing so is the nominal interest rate. — 3

Marks

7. (a) Any two reasons as follows: 3@, max: 6

- wealth effect: Price level decreases $\Rightarrow$ wealth increases (in real terms) $\Rightarrow$ consumption expenditure increases $\Rightarrow$ income increases

- interest rate effect: Price level decreases $\Rightarrow$ real interest rate decreases $\Rightarrow$ investment expenditure increases $\Rightarrow$ income increases

- exchange rate effect: Price level decreases $\Rightarrow$ exports becomes relatively cheaper and imports becomes relatively more expensive $\Rightarrow$ net exports increases $\Rightarrow$ income increases

(b) An increase in government consumption expenditure will shift the AD curve to the right, leading to an increase in real income in the short run. But in the long run, real income will not be affected because the long run AS curve is vertical at the potential income level. 3

OR If the government spends its money on investment, the accumulation of capital may raise potential income. In this case, an expansionary fiscal policy may increase real income in the long run.

8. (a) Given $Y = C + I + G + NX$ 2

$$\begin{aligned} S &= Y - C - G \\ &= C + I + G + NX - C - G \\ &= I + NX \\ &\Rightarrow S - I = NX \end{aligned}$$

(b) (i) From $S - I = NX$, 3

$$S^P + S^G - I = NX$$

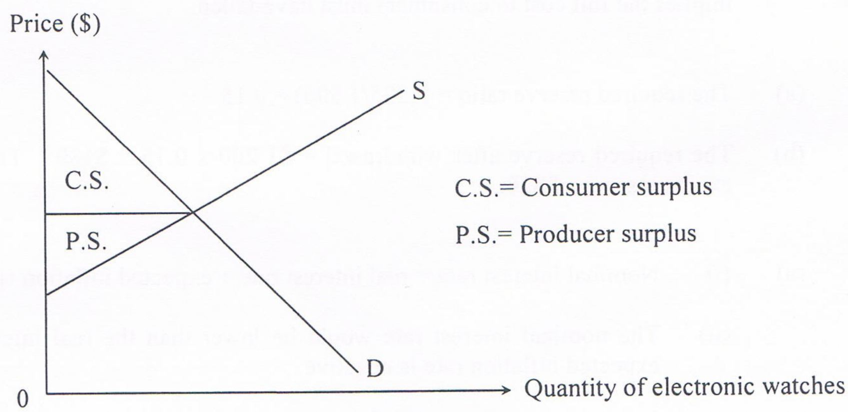
$$S^P = I \quad \Rightarrow \quad S^G = NX$$

(ii) Given $S^P + S^G - I = NX$, $NX = 0$ iff $S^P - I = -S^G$ 3

i.e. the excess of private saving over domestic investment exactly offsets the fiscal deficit.

Section B

9. (a) 2



(b) Supply will increase, resulting in a lower price, a larger quantity transacted, larger consumer surplus and larger producer surplus*. 5

*Remark : The result of larger producer surplus holds when the supply curve shifts in a parallel manner.

Marks

9. (c) (i) It is a variable cost because it varies with output. 2

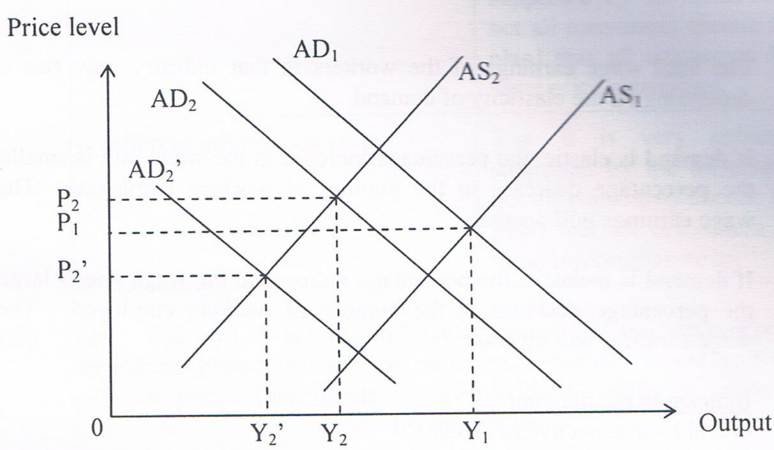
(ii) 600 1

(iii) 600 1

(d) (i) Limited company (not listed on the stock exchange). 1

(ii) No, because his liability is limited only to the amount that he invested or he promised to invest. 2

10. (a) A reduction in firms' willingness to supply goods and services will lead to a leftward shift of the AS curve while a reduction in their willingness to invest will lead to a leftward shift of the AD curve. As a result, output will decrease and the price level may rise or fall, depending on the magnitude of the shifts in the AD and AS curves. 10



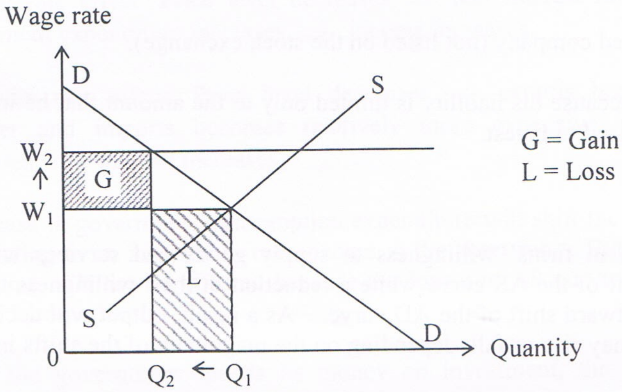
(b) (i) When the price level rises, the government *could* stabilize the price level by a contractionary monetary policy, yet output will decrease further. 4

When the price level falls, the government *could* stabilize the price level by an expansionary monetary policy, which will offset part of the decrease in output. 4

(ii) Given the output-destabilizing possibilities of such monetary policies, whether it *should* stabilize the price level depends on the costs of such output-destabilization (in the former case) and ultimately on the society's preference for output stability vis-à-vis price stability. 4

11. (a) (i) The introduction of an effective minimum wage would raise the wage rate and result in a decrease in the number of workers employed in that industry. 4

<u>Indicate in the diagram</u> :
W ↑ and Q ↓



(ii) The total wage earnings of the workers in that industry may rise or fall, depending on the elasticity of demand. 7

If demand is elastic, the percentage increase in the wage rate is smaller than the percentage decrease in the number of workers employed. The total wage earnings will decrease.

If demand is inelastic, the percentage increase in the wage rate is larger than the percentage decrease in the number of workers employed. The total wage earnings will increase.

<u>Indicate in the diagram</u> :
G and L (irrespective of sizes)

(b) A minimum wage would definitely reduce employment and should not be introduced if securing employment is regarded as being in the interest of low-income workers. 7

Workers who manage to secure employment after the introduction of a minimum wage would gain, as they would earn a higher income than before. Those who lost their jobs due to such a law would suffer. There is no objective rule to decide whether or not these results better serve the interests of the workers.

Even if the total wage earnings of the workers are used as the yardstick in making such a decision, a definite answer could not be obtained *ex ante*, as the effect of a minimum wage on the total wage earnings is ambiguous without reference to the empirical data concerning the elasticity of demand for those workers.

With this complication, the question could only be addressed by resorting to value judgments on what constitutes the best interests of the workers.

Marks

Section C

12. (a) (i) Price discrimination occurs when the same good produced (by a producer) at the same cost is sold to different customers at different prices/under different pricing arrangements. 2

(ii) Any two conditions as follows: 2@, max: 4

Conditions for price discrimination	*Whether the service providers meet those conditions*
- the sellers being price searchers	Yes. Mobile phone service providers can set their own prices without losing all customers.
- separable markets	No. Consumers can choose whichever plans they want to join.
- different price elasticities	Yes. It is very unlikely (and supported by the observation that not all consumers choose the same plan) that all consumers have the same price elasticities.
- different information costs	Yes. It is very unlikely (and supported by the observation that not all consumers choose the same plan) that all consumers bear the same information costs.

(iii) Yes. The cost of serving different customers is the same. For the same per-minute phone call service, different customers would end up paying different prices (per-minute charges) with the different plans they had chosen, so it constitutes price discrimination. 4

Alternative answers

With different prices for different plans chosen by different customers, it does not constitute price discrimination when the same pricing arrangement is opened to all customers, i.e., the plans they can choose from and the price for each plan are the same for all customers.

With different prices for different plans chosen by different customers, it constitutes price discrimination when the same pricing arrangement is not opened to all customers, i.e., the plans they can choose from and the price for each plan are not the same for all customers. For example, some plans with discounts are exclusively offered to civil servants.

(b) (i) An increase in production cost will lead to a decrease in supply in a competitive market and thus an increase in the market price. 2

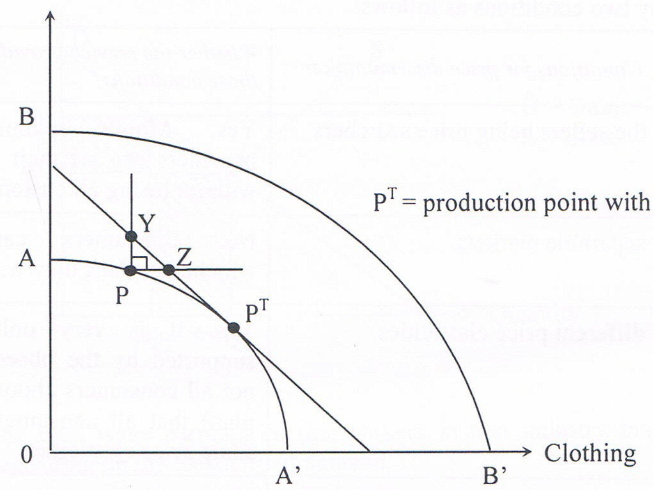
(ii) No, because such behaviour can logically exist in a competitive market. Evidence on collusion between sellers (or data on changes in production cost) would be necessary. 4

Marks

13. (a) 0.5 units of food 1

(b) Clothing, because the opportunity cost of producing clothing is lower than the terms of trade. 3

(c) 4



Country X can gain from trade because it can consume more of both clothing and food within YZ with trade.

(d) (i) The Production Possibility Frontier will shift outwards from AA' to BB'. 2

Country X benefits from such advancement in the sense that the consumption possibilities are greater. 2

(ii)
- adult literacy rate; it indicates whether people have knowledge and education. 2@, max: 4
- life expectancy; it indicates whether people have long and healthy lives.
- any other relevant points