

28. Which of the following will result in a leftward shift of the short run aggregate supply curve?

- A. The general price level falls.
- B. The stock market becomes more volatile.
- C. There is a decrease in birth rate.
- D. The transportation cost of raw materials rises.

29. A country relaxed its immigration requirements to attract foreigners to work, live and study there. It is estimated that 200 000 foreigners will be settling there this year. Which of the following statements about the relaxation of immigration requirements is correct?

- (1) The aggregate demand of the country will rise.
- (2) The labour productivity of the country will rise.
- (3) The short run aggregate supply of the country will rise.

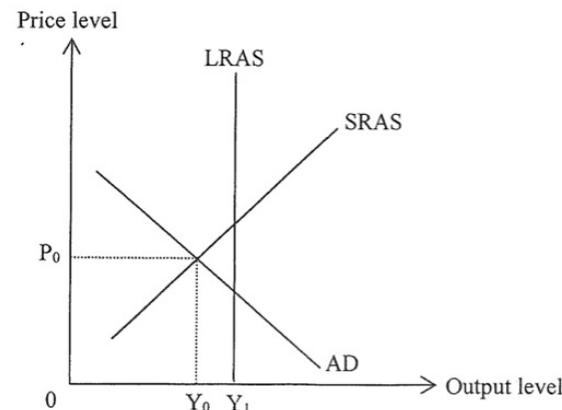
- A. (1) and (2) only
- B. (1) and (3) only
- C. (2) and (3) only
- D. (1), (2) and (3)

37. Which of the following may lead to a rise in aggregate output and an improvement in equity in Hong Kong at the same time?

- (1) a charity fund donating HK\$10 billion to set up non-governmental organisations in order to provide services for the underprivileged
- (2) a cash payout of HK\$10 000 to each permanent resident aged 18 or above by the Government
- (3) a 1% reduction in the standard tax rate of salaries tax

- A. (1) and (2) only
- B. (1) and (3) only
- C. (2) and (3) only
- D. (1), (2) and (3)

38. Study the following diagram.



The initial output level of the economy is  $Y_0$ . Suppose scientists have invented a new oil-refining technology. In the long run,

- (1) the price level will be lower than  $P_0$ .
- (2) the output level will be higher than  $Y_1$ .
- (3) the aggregate demand curve will shift to the right to attain equilibrium.

- A. (1) and (2) only
- B. (1) and (3) only
- C. (2) and (3) only
- D. (1), (2) and (3)

The Mainland government introduced the Targeted Poverty Alleviation Campaign (精準扶貧政策) in 2014. After analysing the situations of people living in poverty, the government officials came up with tailor-made measures. The following are two examples of the campaign.

Example 1	A village in Yunnan province has beautiful natural landscape. The government of Yunnan province promoted the village to attract more travellers. Apart from farming, the villagers also set up hostels to serve travellers in order to earn more income.
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(a) Refer to Example 1.

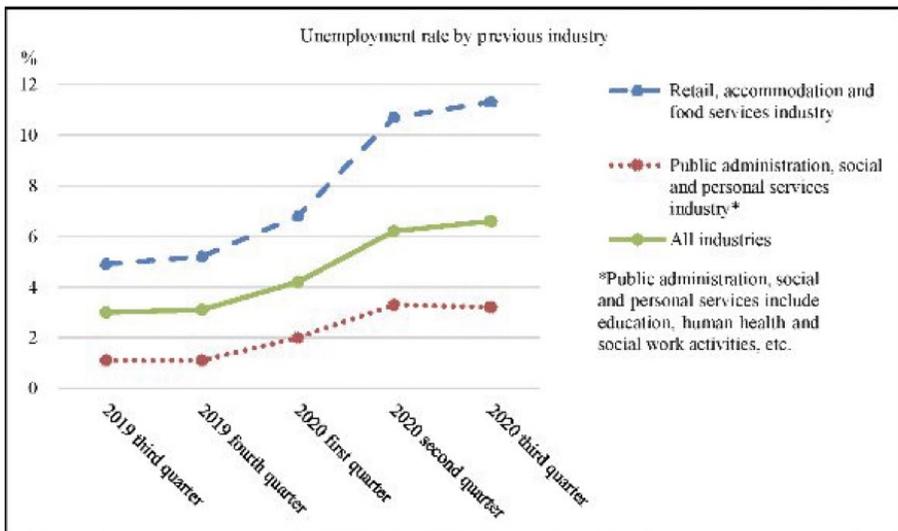
- (i) In which types of production did the villagers engage after the introduction of the campaign? Explain. (4 marks)
- (ii) Explain how labour mobility of the villagers would be affected. (3 marks)

Example 2	The government provided funding and invited private firms to develop hydroelectric power plants in six provinces (such as Hubei and Jiangxi). Such development would help improve transportation, irrigation and flood prevention in the rural villages in these provinces.
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(b) Refer to Example 2. With the aid of a diagram, explain how aggregate output in these six provinces would be affected in the long run. (8 marks)

11. The Government launched the Consumption Voucher Scheme in 2021 to relieve the impact of COVID-19 on the Hong Kong economy.

Source A: Statistical data about unemployment rate in Hong Kong



Source B: An extract of information about the Consumption Voucher Scheme

All Hong Kong permanent residents and new arrivals aged 18 or above, who comply with the 'residing in Hong Kong' requirement, could register to receive electronic consumption vouchers with a total value of \$5 000 by instalments.

Source C: Information about the four designated stored value facilities to receive the \$5 000 consumption vouchers by instalments

	AlipayHK	Octopus	Tap & Go	WeChat Pay HK
Public transportation with the above payment facilities installed	MTR, bus, mini bus and ferry	MTR, bus, mini bus and ferry	Bus and mini bus	None
Promotions to consumption voucher users	5 e-coupons	First 2 million registered customers enjoy \$18 of stored value	\$50 awarded when using virtual Tap & Go Unionpay card for the first transaction with an amount equal to or larger than \$50	e-coupons

For part (e), candidates are required to present their answers in essay form. Criteria for marking will include use of sources and economic theories, relevant content, logical presentation and clarity of expression.

- (e) Suppose the Government plans to spend another sum of money to cope with the pandemic. The following are two suggestions.

Scheme C	Distribute the sum of money using the same mechanism as the existing Consumption Voucher Scheme.
Scheme H	Spend the sum of money on building new hospitals and hiring additional medical staff.

With reference to the above sources and your own knowledge in Economics, discuss which scheme the Government will prefer in order to achieve EACH of the following policy objectives respectively.

- Objective 1: to relieve unemployment in an industry severely affected by the pandemic
- Objective 2: to increase average labour productivity
- Objective 3: to increase aggregate output (in the short run and/or in the long run)

(14 marks)

[Use a separate paragraph for comparing the effects of the two schemes under each policy objective.]

## SECTION 6: AGGREGATE DEMAND AND AGGREGATE SUPPLY

(Note: Despite the fact that the AD-AS model was not explicitly required in the CE and AL syllabuses, in tackling a number of CE/AL questions, the AD-AS framework can still be applied.)

### 6.1 DEMAND- AND SUPPLY-SIDE FACTORS AFFECTING NATIONAL INCOME

#### Multiple Choice Questions

1990/CE/11/37

The national income of a country will tend to increase if

- A. the government increases its budget surplus.
- B. the government raises the interest rates.
- C. the government reduces the profits tax rates.
- D. the demand for exports decreases.

1991/CE/11/41

Which of the following is the main reason for the building of a new airport on Lantau Island in the near future?

- A. to solve the problem of the labour shortage in Hong Kong
- B. to improve the infrastructure of Hong Kong
- C. to control the rising inflation rate
- D. to improve the occupational mobility of construction workers

1991/CE/11/45

Which of the following is most likely to lead to a fall in the inflation rate?

- A. an increase in the money supply
- B. an increase in the interest rate
- C. an increase in government expenditure
- D. an increase in indirect tax

1992/CE/11/49

Which of the following can help to control cost-push inflation in Hong Kong?

- A. an increase in indirect tax rates
- B. a significant increase in productivity
- C. a ban on the importation of labour
- D. an increase in the interest rate

1993/CE/11/38

Which of the following government policies will have an expansionary effect on the economy?

- A. increasing the transfer payments by using its fiscal reserves
- B. spending more money on imports
- C. introducing a general sales tax
- D. raising the reserve requirements of commercial banks

1993/CE/11/43

In Hong Kong, inflation at the consumer level has remained at around 10% for the past few years. Which of the following are two possible reasons for this phenomenon?

- (1) a recession affecting western economies
  - (2) the surplus budgetary policy of the government
  - (3) low interest rates for bank deposits and loans
  - (4) an inflow of capital from China
- A. (1) and (2) only  
B. (1) and (4) only  
C. (2) and (3) only  
D. (3) and (4) only

1993/CE/11/51

An increase in exports and a decrease in imports will cause the national income to

- A. increase  
B. decrease  
C. remain unchanged  
D. either increase or decrease

1997/CE/11/22

It is expected that there will be a record-high number of tourists visiting Hong Kong in the year 1997. This will increase Hong Kong's

- A. GDP.  
B. visible trade.  
C. net external factor income flows.  
D. consumer price index (A).

1997/CE/11/44

Which of the following would have an expansionary effect on the Hong Kong economy?

- A. a raise of the rental of public housing units  
B. the sale of existing public housing units to their tenants  
C. the introduction of a new tax to suppress speculative activities in the property market  
D. an increase in the construction of Home-Ownership-Scheme housing

1997/CE/11/46

Suppose the Hong Kong government spends \$2 billion in the construction of a new highway which is financed by its fiscal reserve. Which of the following would most likely occur?

- A. a narrower wealth gap between the rich and the poor  
B. an increase in the employment rate  
C. an increase in the inflation rate  
D. a budget deficit in the years of construction

2000/CE/11/34

More Hong Kong people shop in Shenzhen and the real interest rate in Hong Kong is increasing and being sustained at a higher level.

Which of the following GDP components of Hong Kong would be least likely affected by the above situation?

- A. domestic consumption (C)  
B. private investment (I)  
C. government expenditure (G)  
D. net export (X - M)

2000/CE/11/38

Which of the following would **MOST LIKELY** increase employment during an economic downturn?

- A. restructuring of private firms to improve their efficiency.  
B. increasing computerization and automation of production process  
C. government's injection of a large amount of funds to help small enterprise.  
D. increasing real interest rates

2001/CE/11/30

Which of the following changes would reduce unemployment?

- A. The government introduces a minimum wage law.  
B. The profits tax rate is raised.  
C. Many domestic firms try to use more labour-saving machines.  
D. The demand for the country's exports increases.

2004/CE/11/31

Which of the following is both a demand-side factor and a supply-side factor affecting national income?

- A. the government's productivity-enhancement projects  
B. the government's promotion of tourism  
C. a 'buying local products' campaign  
D. a firework show sponsored by private firms

2005/CE/11/30

Which of the following would result in an increase in Hong Kong's GDP?

- A. The government increases the profits tax rate.  
B. There is a fall in the total export value of Hong Kong made toys.  
C. The government develops the Western Kowloon cultural district.  
D. There are more Hong Kong people traveling in foreign countries.

2006/CE/11/32

Which of the following would most likely raise the potential GDP (i.e., production capacity) of an economy?

- A. an increase in the social welfare benefit  
B. an increase in the reserve ratio of the banking system  
C. an increase in the government expenditure on tertiary education  
D. an increase in the demand for the economy's exports

2019/DSE/1/27

Country A is an oil-importing country. Which of the following will result in a rightward shift of its short-run aggregate supply curve?

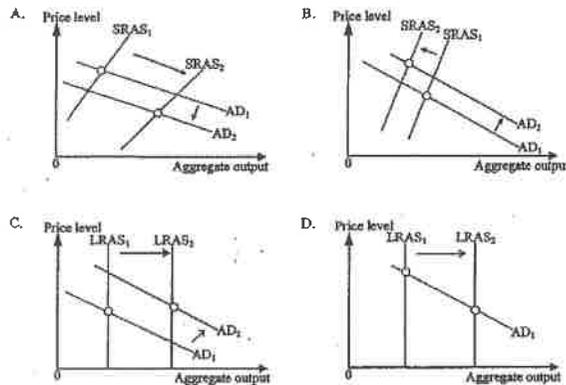
- A. All oil-exporting countries decide to increase the daily production of oil.
- B. Extreme cold weather sharply raises the consumption of oil for heating in Country A.
- C. The government of Country A provides tax relief for research in new energy aiming to lessen the reliance on oil.
- D. An earthquake destroys an oil refinery factory in Country A.

2019/DSE/1/38

The government carried out the following two policies:

Policy one:	Reduce the profits tax rate for corporations with profit less than two million dollars.
Policy two:	Inject fifty billion dollars to develop innovation and technology.

Which of the following AD-AS diagrams could most likely show the effect on aggregate output caused by the above two policies?



2020/DSE/1/27

Which of the following is a reason for a leftward shift of the short run aggregate supply curve in a country?

- A. There is a continuous increase in price level.
- B. The largest market of the country's exports suffers from an economic recession.
- C. More citizens emigrate to foreign countries.
- D. The wages of labour slowly adjust downward due to institutional factors.

2020/DSE/1/35

Which of the following policies would offset the effect of an increase in the willingness to invest on the price level?

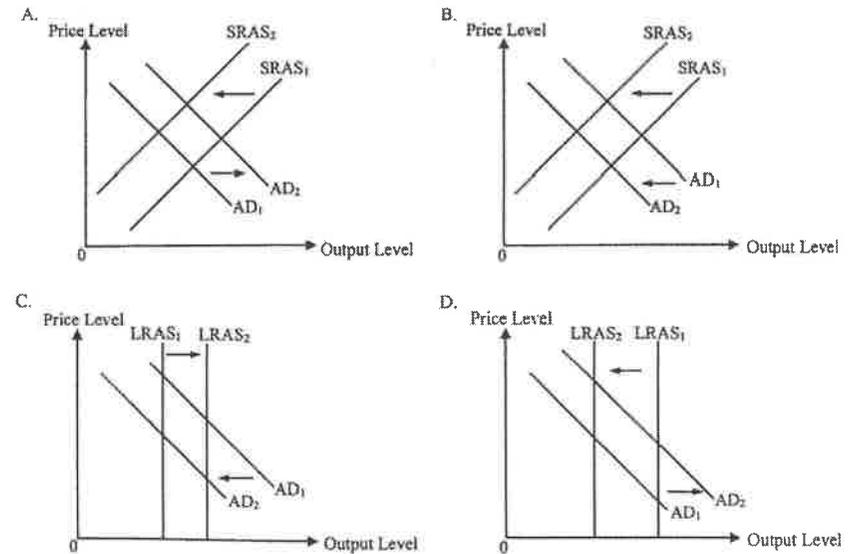
- (1) an increase in profits tax rate
- (2) an increase in transfer payment
- (3) a decrease in tax allowance

- A. (1) and (2) only
- B. (1) and (3) only
- C. (2) and (3) only
- D. (1), (2) and (3)

2021/DSE/1/36

Due to the COVID-19 outbreak, most of the flights were cancelled, leading to a significant drop in the number of tourists visiting Hong Kong. At the same time, many employees in Hong Kong were forced to take no pay leave.

Which of the following diagrams can best describe the consequence of the above incidents?



2008/CE/11/28

If the government constructs the Tuen Mun-Chek Lap Kok Link (屯門至赤鱗角連接路) to link up Shenzhen and the Hong Kong International Airport, the \_\_\_\_\_ of Hong Kong will increase.

- (1) employment
- (2) actual GDP
- (3) potential GDP

- A. (1) and (2) only
- B. (1) and (3) only
- C. (2) and (3) only
- D. (1), (2) and (3)

Short & Structured Questions

1990/CE/1/3(b)(i)

Explain how a depreciation of the Hong Kong dollar might lead to a higher inflation rate in Hong Kong. (6 marks)

1990/CE/1/05(b)(ii)

Suppose the Hong Kong government adopts the following tax policies:

- Policy A: introducing a 3% sales tax on all commodities
- Policy B: cutting down the standard tax rate by 3%

Explain how **EACH** of the above policies affects the general price level. (6 marks)

1992/CE/1/5(c)

It has now been decided that a new airport will be built at Chek Lap Kok

- (ii) What is meant by inflation? (2 marks)
- (iii) Explain briefly how the construction of the new airport might cause inflation in Hong Kong. (4 marks)

1994/CE/1/10(a)(ii)

A government borrows a large sum of money from foreign countries and spends it on infrastructure. State the benefits of the increase in government spending on the local construction workers and the economy as a whole. (4 marks)

1995/CE/1/9(c)

The World Cup of 1994 was held in the USA. People from all over the world went to the US to watch the matches.

- (i) Name any **TWO** demand side factors affecting national income. (2 marks)
- (ii) The holding of the World Cup was favourable to the gross domestic product (GDP) of the US. Explain this by referring to the **TWO** demand side factors you mentioned in (e)(i). (6 marks)

1996/CE/1/12(c)

The government has organised a worker retraining programme for the unemployed. Explain, with **ONE** demand side factor and **ONE** supply side factor, the effect of such a programme on Hong Kong's GDP. (5 marks)

1997/CE/1/9(d)(i)

Suppose a general sales tax is introduced to finance the construction of the new railway. Explain the effect of this tax on Hong Kong's price level. (2 marks)

2004/CE/1/10(c)

To lessen the negative effect of SARS on our economy, the government partially rebated the salaries tax to taxpayers. Explain how the tax rebate could lead to an increase in the GDP of Hong Kong. (4 marks)

2005/CE/1/11(a)

Two measures included in the Closer Economic Partnership Arrangement or 'Cepa' are:

- I. Zero tariff on 90% of Hong Kong-made products to the Chinese mainland
- II. Faster / easier market entry to the Chinese mainland for Hong Kong-based service providers in 18 service sectors

As a result, overseas companies not based in Hong Kong can take advantage of Cepa by partnering with a Cepa-qualified manufacturer or service provider in Hong Kong.

Source: Hong Kong SAR Government, 8 January 2005

Explain, separately, how the above two measures would affect the gross domestic product of Hong Kong. (5 marks)

2007/CE/1/8(b)(ii)

The universities in Hong Kong do not only admit local students. Since last year, these universities have begun to admit a large number of top-quality Mainland students. Suppose all students pay the same tuition fees. Suppose these top-quality Mainland students stay and work in Hong Kong after their graduation and the total number of job positions in Hong Kong remains unchanged.

Give **TWO** reasons to explain how this situation would lead to an increase in the potential gross domestic product of Hong Kong. (2 marks)

2009/CE/1/10(a)

The direct cross-strait flights (兩岸直航) between mainland China and Taiwan introduced in 2008 facilitate the trading activities between these two places.

The GDP of Taiwan would probably increase with the introduction of the direct cross-strait flights. With reference to **TWO** demand-side factors, explain why there is such a possibility. (4 marks)

2010/CE/1/9(c)

Ocean Park Hong Kong is undergoing a major redevelopment plan. Ocean Park will expand to double the number of its attractions. In addition, Ocean Park is planning three themed hotels (the Spa Hotel, Ocean Hotel, and Fisherman's Wharf Hotel) in the area for an expected increase in visitors.

For each of the following situations explain your answer with reference to **ONE** demand-side factor. Why would the above expansion increase the gross domestic product (GDP) of Hong Kong

- (i) during the construction period? (2 marks)
- (ii) after the completion of the construction? (2 marks)

The following table shows the changes in the individual income tax system in China effective from October 2018.

Average tax rate	Range of monthly taxable income, in Renminbi (RMB)	
	Old brackets	New brackets
3%	Less than or equal to 1500	Less than or equal to 3000
10%	1501 – 4500	3001 – 12000
20%	4501 – 9000	12001 – 25000
25%	9001 – 35000	25001 – 35000
30%	35001 – 55000	Unchanged
35%	55001 – 80000	Unchanged
45%	Greater than 80000	Unchanged

- (b) Suppose there is a deflationary (output) gap in China economy. With the aid of an AS-AD diagram, explain how the above change of the individual income tax system would affect the deflationary (output) gap in the short run. (7 marks)
- (c) To achieve the same effect on the deflationary (output) gap as in part (b), an economist suggested the government should lower the required reserve ratio of banks instead of implementing the above change in tax system. Discuss the suggestion by giving ONE argument FOR and ONE argument AGAINST it. (4 marks)

2020/DSE/II/9D

- (d) The contribution of the infrastructure development of Ocean Park to Hong Kong's GDP in 2019 could be smaller than the total amount invested in the two hotels and the water park. Explain why the statement may be correct with TWO reasons. (4 marks)

## MARKING SCHEME

1990/CE/II/37 C	1993/CE/II/38 A	1997/CE/II/44 D	2001/CE/II/30 D	2008/CE/II/28 D (55%)
1991/CE/II/41 B	1993/CE/II/43 D	1997/CE/II/46 B	2004/CE/II/31 A (31%)	2019/DSE/II/27 A
1991/CE/II/45 B	1993/CE/II/51 A	2000/CE/II/34 C	2005/CE/II/30 C (73%)	2019/DSE/II/38 C
1992/CE/II/49 B	1997/CE/II/22 A	2000/CE/II/38 C	2006/CE/II/32 C (48%)	2020/DSE/II/27 C
2020/DSE/II/35 B	2021/DSE/II/36 B			

1990/CE/II/3(b)(i)  
HK\$ depreciate

- ⇒ Export prices ↓
- ⇒ Export volume ↑
- ⇒ Boom in export sector
- ⇒ Aggregate demand ↑ ⇒ price level ↑

(1)  
(2)  
(2)  
(2)  
(max: 6)

1990/CE/II/05(b)(ii)

- ↑ sales tax on all commodities ⇒ prices of all goods ↑
- ↓ standard rate ⇒ income after tax of the rich ↑
- ⇒ consumption ↑ ⇒ aggregate demand ↑ ⇒ general price level ↑

(2)  
(4)

1992/CE/II/5(c)

- (ii) a continuous rise in the general price level

(2)

(iii) Construction of the airport

- ⇒ ↑ in aggregate demand for resources / demand for workers
- ⇒ inflation occurs when Hong Kong is near full employment

(2)  
(2)

1994/CE/II/10(a)(ii)

Local construction workers:

- more job opportunities
- income ↑

Whole economy:

- consumption expenditure ↑ / more business
- GNP ↑
- employment ↑
- social capital ↑
- higher economic growth

(1@, max: 4)

1995/CEA/9(c)  
(i) - consumption expenditure  
- investment expenditure  
- government expenditure  
- exports or net export  
- imports or net export  
(Mark the **FIRST TWO** points only.) (1@, max: 2)

(ii) [Note: the answer must match with the answer to (c)(i)]  
Consumption expenditure  $\uparrow \Rightarrow$  GDP  $\uparrow$  (1)  
e.g. US residents spent more on food, hotel accommodation, traveling, souvenirs, etc. (2)  
**OR**  
Investment expenditure  $\uparrow \Rightarrow$  GDP  $\uparrow$  (1)  
e.g. more investment in the provision of transport service, accommodation, food supplies, etc. (2)  
**OR**  
Government expenditure  $\uparrow \Rightarrow$  GDP  $\uparrow$  (1)  
e.g. US government expenditure on infrastructure related to the event, expansion / maintenance of stadiums, etc. (2)  
**OR**  
Net exports  $\uparrow \Rightarrow$  GDP  $\uparrow$  (1)  
e.g. more tourists' spending on transport, accommodation, food, clothing, souvenirs, etc. (2)  
(3@, max: 6)

1996/CEA/12(c)  
Demand-side factor:  
- government expenditure (in current year) increases (2)  
Supply-side factor:  
- the labour productivity would be raised (2)  
**OR**  
- labour supply would increase because workers originally outside the labour force will be attracted (2)  
 $\therefore$  GDP (both in current year and in future) would increase. (2)  
(max: 2)  
(Mark the **FIRST** demand-side factor and the **FIRST** supply-side factor only.) (1)

1997/CEA/9(d)(i)  
prices of most goods and services after tax  $\uparrow$  / cost of production  $\uparrow$  / supply of goods and services  $\downarrow$  (1)  
 $\therefore$  price level  $\uparrow$  (1)

2004/CEA/10  
After-tax income (i.e. "disposable income") increased (2)  
Consumption expenditure would increase. (2)  
 $\therefore$  GDP would increase. (2)

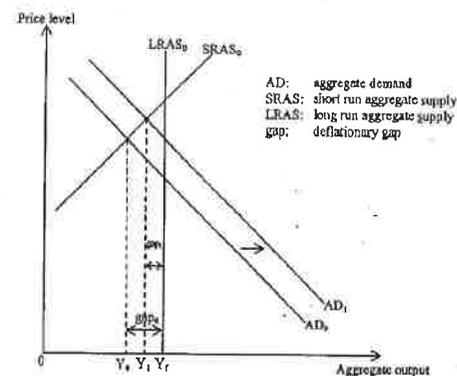
2005/CEA/11(a)  
Zero tariff encourages more export of goods. (2)  
Easier market entry encourages more investment. (2)  
Both measures will increase the GDP of Hong Kong. (1)

2007/CEA/8(b)(ii)  
- a larger labour force  
- These top-quality Mainland students have a higher productivity.  
- These top-quality Mainland students can increase the productivity of the local employees when they work together / brings knowledge and new ideas to Hong Kong. (1@, max: 2)  
[Mark the **FIRST TWO** points only]

2009/CEA/10(a)  
- net exports: more net exports (or more export of services) due to more tourists from mainland China  
- consumption: more earnings and income will boost consumption expenditure  
- investment: more investment (local and from the Mainland), e.g., more hotels and trading firms.  
- government expenditure: more government expenditure, e.g., more on infrastructure to facilitate the trade (2@, max: 4)

2010/CEA/9(c)  
(i) - more facilities (attractions) will be constructed  $\Rightarrow$  increase in investment expenditure (2)  
(ii) - more tourists from mainland China and other places  $\Rightarrow$  increase in net exports (export of services)  
**OR**  
- more local visitors  $\Rightarrow$  increase in private consumption expenditure (2)

2019/DSE/II/10  
(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 (1)  
- correct new Y with a smaller gap (1)



**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

D) The investment may include importer raw material which is not the contribution of local resident producing unit.

The investment may include the value of inventories which are not produced in current year.  
The investment may include the value of intermediate goods ( electricity and other raw materials ) which are the contribution of other resident producing unit.

( Mark the first 2 answers ) ( 3 marks )

## 6.2 LONG RUN AND SHORT-RUN EQUILIBRIUM

### Multiple Choice Questions

1994/AL/II/9

The existence of a deflationary gap indicates that

- (1) the equilibrium income is below the full employment income.
  - (2) a surplus budget should be used to eliminate the gap.
  - (3) the economy has insufficient aggregate demand to achieve full employment.
  - (4) the real income is smaller than the nominal income.
- A. (1) and (3) only  
B. (1) and (4) only  
C. (2) and (3) only  
D. (2) and (4) only

1997/AL/II/21

Which of the following policies can be used to offset the effect of an increase in the saving of the households on the national income of an economy?

- A. an increase in the tax rate.  
B. a decrease in money supply.  
C. sales of government bonds by the central bank.  
D. a cut on the required reserve ratio of the banking sector.

1999/AL/II/4

The existence of an inflationary gap indicates that

- A. there is a gap between the actual inflation rate and the expected inflation rate.  
B. there is a gap between real income and nominal income, and the gap is caused by inflation.  
C. there is excess demand for aggregate output at the full employment level of income, which therefore falls short of the equilibrium level of income.  
D. All of the above.

2000/AL/II/20

Which of the following can raise the employment level of an economy?

- (1) export promotion
  - (2) increase in foreign investment in the economy
  - (3) reduction in the income tax rate
- A. (1) and (2) only  
B. (1) and (3) only  
C. (2) and (3) only  
D. (1), (2) and (3)

2001/AL/11/14

Suppose country A and country B trade with each other and the imports of each country are a function of its own national income. If there is an increase in investment expenditure in country A, then

- A. the national income of both country A and country B will increase.
- B. the national income of country A increases but the national income of country B remains unchanged.
- C. the national income of country A increases but the national income of country B may either increase or decrease.
- D. the national income of each country may either increase or decrease.

2012/AL/11/30

With the existence of a deflationary gap

- A. real income is lower than nominal income.
- B. the economy has a rising deflation rate.
- C. the economy has insufficient aggregate demand to achieve full employment.
- D. the government can employ a surplus budget to eliminate the gap.

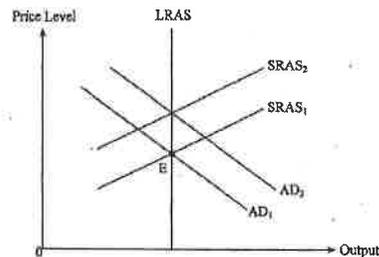
2012/DSE/1/25

Which of the following will lead to a decrease in aggregate demand?

- A. a rise in private saving
- B. a rise in investment expenditure
- C. a fall in imports
- D. a fall in the progressivity of income tax

2012/DSE/1/26

The diagram below shows the aggregate demand (AD) curves, the short run aggregate supply (SRAS) curves and the long run aggregate supply (LRAS) curve of a country. Point E is the initial equilibrium point.



When there is an economic recovery in the country's major trading partner, \_\_\_\_\_ in the short run and \_\_\_\_\_ in the long run.

- A.  $AD_1$  will shift to  $AD_2$  .....  $SRAS_1$  will shift to  $SRAS_2$
- B.  $AD_1$  will shift to  $AD_2$  .....  $AD_2$  will shift back to  $AD_1$
- C.  $SRAS_1$  will shift to  $SRAS_2$  .....  $AD_1$  will shift to  $AD_2$
- D.  $SRAS_1$  will shift to  $SRAS_2$  .....  $SRAS_2$  will shift back to  $SRAS_1$

2012/DSE/1/34

Suppose the government spends \$3 billion on the construction of a cruise terminal which is financed from its reserves. This will result in

- (1) an increase in aggregate output in the short run.
- (2) an increase in aggregate output in the long run.
- (3) an increase in employment in the short run.
- (4) a budget deficit in the years of construction.

- A. (1) and (3) only
- B. (2) and (4) only
- C. (1), (2) and (3) only
- D. (1), (3) and (4) only

2012/DSE/1/36

Which of the following can offset the effect of a decrease in income tax rate on aggregate demand?

- A. a decrease in the asset demand for money
- B. a decrease in the desire to import
- C. an increase in the desire to invest
- D. an increase in the required reserve ratio

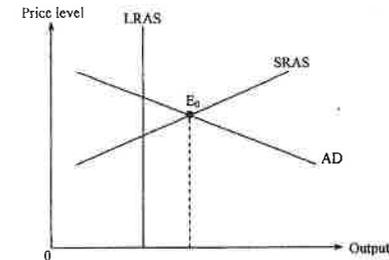
2013/DSE/1/23

The aggregate demand curve will shift to the right if

- A. there is a fall in the price level
- B. there is an improvement in technology
- C. the government reduces the import tariff
- D. the government reduces the salaries tax rate

2013/DSE/1/24

The diagram below shows the aggregate demand (AD) curves, the short run aggregate supply (SRAS) curve and the long run aggregate supply (LRAS) curve of an economy.

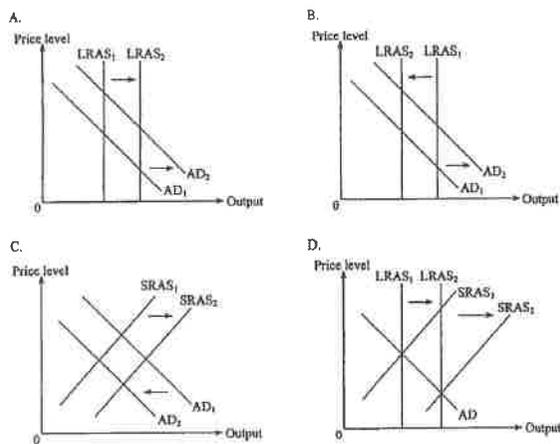


Suppose initially the economy operates at  $E_0$ . There is a/an \_\_\_\_\_ and \_\_\_\_\_ can help restore the long run equilibrium.

- A. inflationary (output) gap ..... a rise in transfer payments to the poor
- B. inflationary (output) gap ..... a rise in the discount rate
- C. deflationary (output) gap ..... a rise in transfer payments to the poor
- D. deflationary (output) gap ..... a rise in the discount rate

2013/DSE/I/29

Suppose the government greatly increases the tax allowance on continuing education. Which of the following can best explain the effect of the above change on the price and output levels?

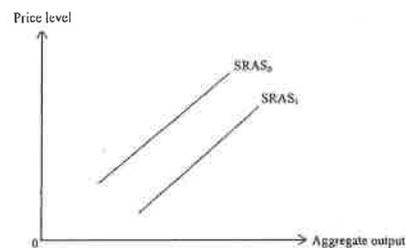


2013/DSE/I/30

If there is a decrease in the desire to consume, the net exports of an economy will \_\_\_\_\_ and the amount of money held for transaction purposes will \_\_\_\_\_.

- A. decrease ..... decrease
- B. decrease ..... remain constant
- C. increase ..... increase
- D. increase ..... decrease

2014/DSE/I/27



Refer to the above diagram. Which of the following would most likely lead to the shift of the short run aggregate supply curve from  $SRAS_0$  to  $SRAS_1$ ?

- A. to relax the quota for foreign domestic helpers
- B. to reduce the subsidy in research and development
- C. to increase the profits tax rate
- D. to increase the number of places in tertiary education

2014/DSE/I/28

Old Age Living Allowance (長者生活津貼) introduced by the Hong Kong government increases the \_\_\_\_\_ in GDP and results in a \_\_\_\_\_ shift of the aggregate demand curve.

- A. government consumption expenditure ..... rightward
- B. government consumption expenditure ..... leftward
- C. private consumption expenditure ..... rightward
- D. private consumption expenditure ..... leftward

2014/DSE/I/29

If there is a decrease in national income of a major trading partner of an economy, the employment of the economy will \_\_\_\_\_ and the price level will \_\_\_\_\_ in the short run.

- A. increase ..... increase
- B. increase ..... decrease
- C. decrease ..... increase
- D. decrease ..... decrease

2014/DSE/I/34

Deflationary (output) gap

- A. will be widened when there is a depreciation of the domestic currency.
- B. will be eliminated by a rightward shift of the aggregate demand curve when the market adjusts from short run equilibrium to long run equilibrium.
- C. will result in a downward pressure on the prices of inputs.
- D. will exist if the aggregate demand falls short of the short run aggregate supply.

2014/DSE/I/35

Which of the following policies can the government introduce to reduce the price and unemployment levels at the same time?

- A. to raise the discount rates
- B. to raise the subsidies to small and medium-sized enterprises
- C. to raise the salaries tax rate
- D. to raise the expenditure on social welfare

2014/DSE/I/38

Which of the following government policies will lead to an increase in the aggregate output of a country in the long run?

- (1) to tighten regulations on environmental protection
  - (2) to grant an amnesty (特赦) to illegal immigrants
  - (3) to ban the importation of foreign domestic helpers
  - (4) to build more international schools for attracting expatriates to work in the country
- A. (1) and (3) only
  - B. (1) and (4) only
  - C. (2) and (3) only
  - D. (2) and (4) only

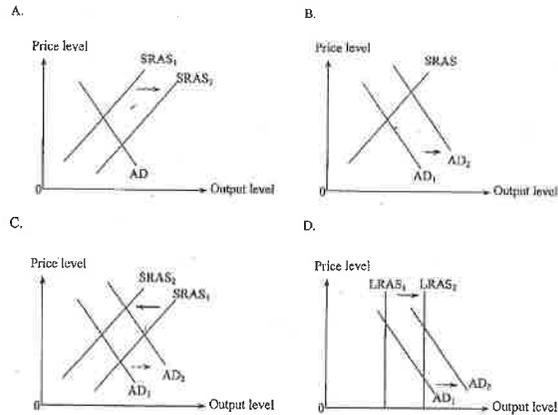
2015/DSE/I/26

Which of the following will result in a rightward shift of the aggregate demand curve of a country?

- A. The central bank reduces the discount rate.
- B. The minimum wage rate is increased.
- C. The general price level decreases.
- D. Its trading partners suffer from an economic recession.

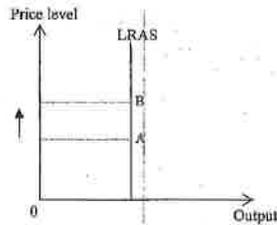
2015/DSE/I/27

The government provides cash subsidies for new-born children from their birth to age 10. Which of the following diagrams best illustrates the effect of the subsidies on the economy after twenty years?



2015/DSE/I/37

Refer to the following aggregate supply diagram.



When the economy moves from point A to point B, which of the following will **NOT** change?

- (1) real output
  - (2) nominal output
  - (3) potential output
- A. (1) only  
B. (2) only  
C. (1) and (3) only  
D. (1), (2) and (3)

2015/DSE/I/38

Initially an economy operates at the long-run equilibrium. Which of the following will lead to a deflationary (output) gap in the economy?

- A. The government increases the salaries tax rate.
- B. The government reduces the profits tax rate.
- C. The government invests in the construction of a cross-border express rail link.
- D. The central bank reduces the required reserve ratio.

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2015/DSE/I/39

In an economy with severe inflation and income inequality, the government can lower the price level and reduce the income gap by

- A. increasing the environmental tax on handling household sewage.
- B. increasing the salaries tax and its progressivity.
- C. reducing its spending on social welfare.
- D. reducing the personal allowance of the salaries tax.

2016/DSE/I/26

The aggregate demand of a country will drop if

- A. the price level of the country rises.
- B. the currency of its major trading partner appreciates.
- C. the government spending on social welfare rises.
- D. the required reserve ratio rises.

2016/DSE/I/27

If the government builds new infrastructures, there will be an increase in

- (1) employed population during the construction period.
- (2) the price level during the construction period.
- (3) potential output after the construction is completed.
- (4) the price level after the construction is completed.

- A. (1) and (2) only  
B. (3) and (4) only  
C. (1), (2) and (3) only  
D. (1), (2), (3) and (4)

2016/DSE/I/28

The 'multiple entry permit' (一簽多行) for the permanent Shenzhen residents to visit Hong Kong has been replaced by a 'one trip per week cap' (一週一行). This would reduce Hong Kong's \_\_\_\_\_ and \_\_\_\_\_.

- A. aggregate demand ..... output level in the long run
- B. aggregate demand ..... price level in the long run
- C. short-run aggregate supply ..... output level in the short run
- D. long-run aggregate supply ..... output level in the long run

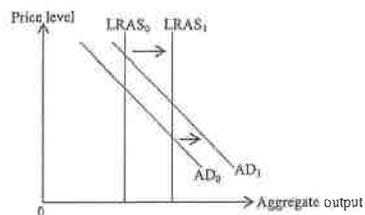
2017/DSE/I/28

The aggregate demand curve of Hong Kong will shift to the left if

- A. the implicit GDP deflator rises continuously.
- B. the government raises the retirement age of all civil servants.
- C. the number of tourists from the Mainland decreases.
- D. the Mainland stock market booms.

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2017/DSE/I/29



The diagram above shows the aggregate demand curves and long run aggregate supply curves of an economy. Which of the following best explains the above changes?

- A. a decrease in people's desire to save
- B. an enhancement in production technology
- C. an increase in national income of the economy's trading partners
- D. an increase in government subsidy on private research and development

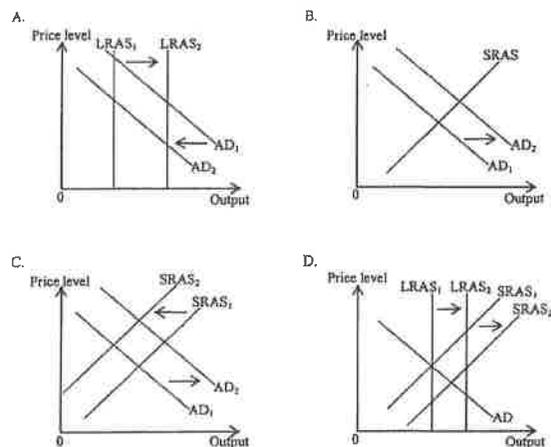
2017/DSE/I/37

Which of the following policies would most likely lead to a drop in aggregate output?

- A. The government bought bonds from the public and raised the tax allowance at the same time.
- B. The government sold bonds to the public and reduced transfer payment to the poor at the same time.
- C. The government reduced required reserve ratio and raised the progressivity of income tax at the same time.
- D. The government increased the discount rate and lowered profits tax rate at the same time.

2017/DSE/I/40

In his 2016-17 Budget, the Financial Secretary proposed to waive business registration fees for 2016-17. At the same time, the personal basic tax allowance was raised from \$120 000 to \$132 000. Which of the following best illustrates the effect of the above changes on the price and output levels?



2018/DSE/I/26

The short run aggregate supply curve will shift to the right if

- A. the government relaxes the importation quota of foreign workers.
- B. the government increases the profits tax rate.
- C. the central bank sells government bonds to the public.
- D. there is an increase in the price level.

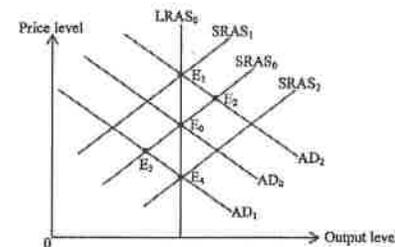
2018/DSE/I/27

Which of the following will lead to an increase in both price level and aggregate output in the short run?

- A. There is an improvement in production technology.
- B. There is an increase in the oil price.
- C. There is a decrease in money supply.
- D. There is a decrease in the desire to save.

2018/DSE/I/28

The diagram below shows the aggregate demand (AD) curves, short run aggregate supply (SRAS) curves and the long run aggregate supply (LRAS) curve of an economy. The economy initially operates at E<sub>0</sub>.



If the government gives \$10 000 cash to every citizen every year, the short-run equilibrium will be at \_\_\_\_\_ and the long-run equilibrium will be at \_\_\_\_\_.

- A. E<sub>2</sub> ..... E<sub>0</sub>
- B. E<sub>2</sub> ..... E<sub>1</sub>
- C. E<sub>3</sub> ..... E<sub>0</sub>
- D. E<sub>3</sub> ..... E<sub>4</sub>

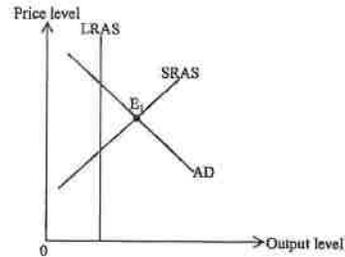
2018/DSE/I/38

Suppose there is a reduction in the basic allowance of the salaries tax in an economy. Which of the following can offset its effect on aggregate demand?

- A. People's desire to save increases.
- B. The price level decreases.
- C. The central bank carries out an open market sale of government bonds.
- D. The required reserve ratio in the banking system decreases.

2018/DSE/1/39

Refer to the AS-AD diagram below.

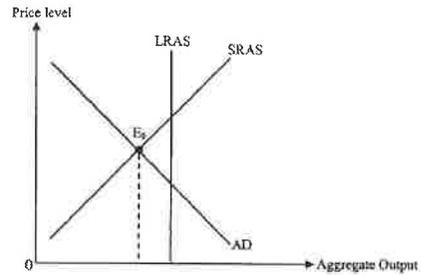


The economy operates at  $E_1$  initially. Which of the following can help the economy restore to the long run equilibrium?

- (1) to reduce the subsidies to small enterprises
  - (2) to increase the required reserve ratio
  - (3) to reduce the discount rate
  - (4) to reduce property tax
- A. (1) and (2) only  
B. (3) and (4) only  
C. (1), (2) and (3) only  
D. (2), (3) and (4) only

2020/DSE/1/36

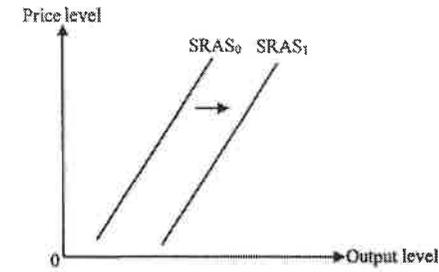
The diagram below shows the aggregate demand curve, the short run aggregate supply curve and the long run aggregate supply curve of an economy.



Suppose the economy initially operates at  $E_0$  and the total import value equals the total export value. If the government decreases the amount of social security assistance for the elderly, in the short run, the deflationary (output) gap will become \_\_\_\_\_ and there will be a \_\_\_\_\_.

- A. narrower ..... trade surplus
- B. narrower ..... trade deficit
- C. wider ..... trade surplus
- D. wider ..... trade deficit

2021/DSE/1/27

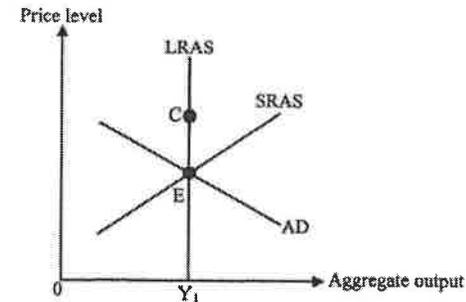


Which of the following is a possible reason of the above shift of the short run aggregate supply curve?

- A. The cost of production increases due to an increase in global demand for oil.
- B. The profitability of firms increases with the rise in price level, since the difference between output prices and input prices increases.
- C. An increase in interest rate leads to an increase in cost of investment.
- D. The operation of labour market resumes to normal after a massive labour strike.

2021/DSE/1/28

Study the following diagram.



The initial equilibrium point of an oil importing country is at  $E$ . If the new long run equilibrium point is at  $C$ , which of the following is a possible reason for the change in the equilibrium point?

- A. There is an increase in oil prices.
- B. There is a decrease in production subsidy.
- C. The public tends to save less.
- D. The government increases the salaries tax rate.

Short & Structured Questions

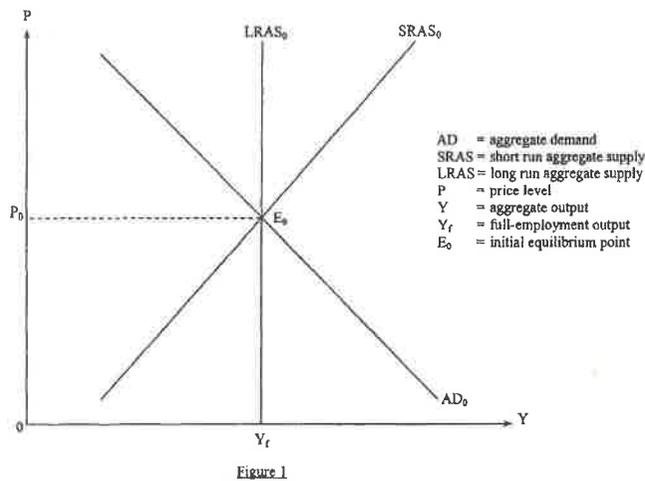
2012/DSE/II/10(c)

In 2011, the Financial Secretary announced the "Scheme \$6 000" which provides \$6 000 to each Hong Kong permanent resident who is 18 years old or above.

With the aid of a diagram, explain how the "Scheme \$6 000" would affect the price and output levels of Hong Kong in the long run. (8 marks)

2013/DSE/II/4

- (a) Give **ONE** reason to explain why the aggregate demand curve is downward sloping. (3 marks)
- (b) Suppose there is an increase in the price of raw materials. With reference to the market adjustment mechanism from the short run equilibrium to the long run equilibrium, explain the long run effect of the above change on the price level with the aid of Figure 1. (9 marks)



2013/DSE/II/12(c)

With the aid of an aggregate-demand-aggregate-supply diagram, explain the short run effects of an upward adjustment of the required reserve ratio on output and the price level of the economy. (8 marks)

2014/DSE/II/10(b)

Source 2 below is an extract from a newspaper article.

Addressing the potential threat brought about by the trends of the birth rate and old dependency ratio in China, government officials are considering relaxing the one-child policy in an effort to boost the birth rate.

<sup>a</sup>The policy restricts urban couples to only one child, while allowing additional children in several cases, including twins, rural couples, ethnic minorities, and couples who are both the only child in their respective families.

With reference to Source 2, discuss the possible effect on the aggregate output in the long run as a result of the relaxation of the one-child policy. (3 marks)

2014/DSE/II/12(c)

The Prime Minister of Japan, Shinza Abe, adopted a series of policy measures in 2013 to expand the Japanese economy. One of the policy measures was stepping up the scale of the purchase of government bonds and other financial assets by the central bank.

What would be the short run effects of the above policy on the output and price levels of the Japanese economy? Explain your answer with the aid of an aggregate-supply-aggregate-demand diagram. (8 marks)

2015/DSE/II/8

The government is considering spending a certain sum of its budget surplus on the following two proposals:

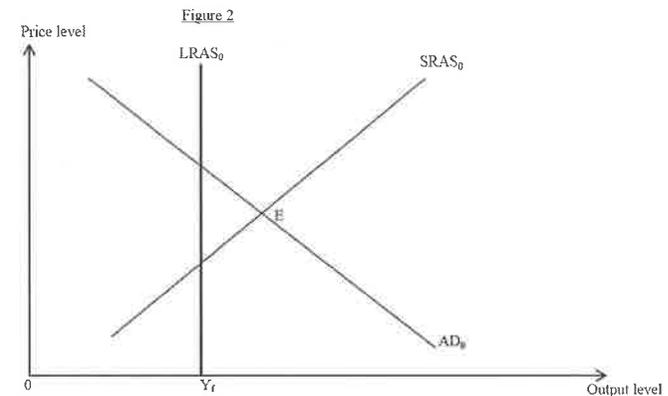
- Proposal 1: To extend the free education to 15 years  
Proposal 2: To provide unemployment benefits

Evaluate the two proposals in terms of the effect on aggregate output. (4 marks)

2015/DSE/II/12

Research shows that the "Individual Visit Scheme" of mainland tourists has brought economic benefits to Hong Kong.

An economist uses the AS-AD model to analyse the current situation in Hong Kong. In his analysis, point E in Figure 2 represents the initial short-run equilibrium of the Hong Kong economy.



(b) He points out that the government can help the economy restore to its long-run equilibrium. With the aid of Figure 2, explain how the reduction in the number of tourists from the mainland can lower the output level to  $Y_f$ . (5 marks)

(c) He also states that even without the help of the government, market forces can restore the economy to its long-run equilibrium. **WITHOUT** using a diagram, explain how market forces can lower the output level to  $Y_f$  in the long run. (4 marks)

2016/DSE/II/5

Explain, with **ONE** reason, why the short-run aggregate supply curve is upward-sloping. (3 marks)

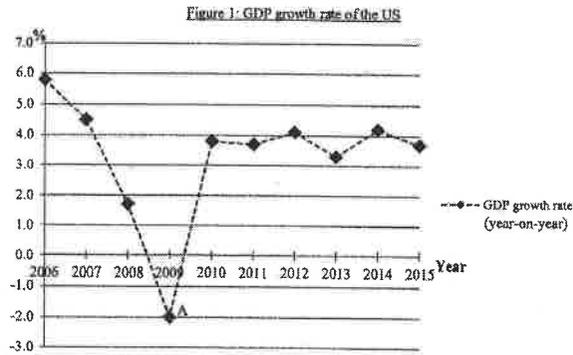
2016/DSE/II/12(b)

The Macau government implements a cash-sharing scheme, under which every resident receives cash from the government.

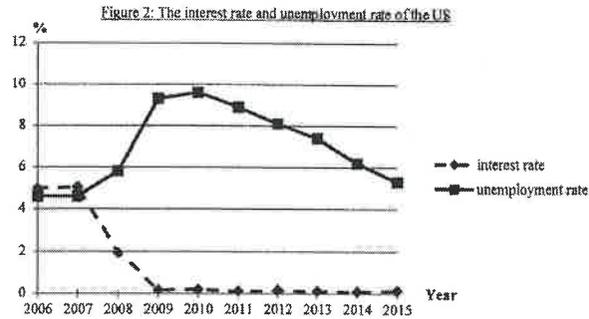
With the aid of an AS-AD diagram, explain how the cash-sharing scheme would affect output and price levels in the short run. (6 marks)

2017/DSE/11/9

Figures 1 and 2 show some macroeconomic data of the US.



- (a) Refer to Figure 1, Identify the phase of business cycle which point A is in. (1 mark)
- (b) How may a reduction in interest rate help the US economy in 2009? Without using a diagram, explain your answer in the light of aggregate supply and/or aggregate demand. (3 marks)



- (c) Discuss whether the data in Figures 1 and 2 are consistent with your answer in (b). (4 marks)
- (d) Suggest **ONE** policy that will help increase the aggregate output in the long run. Briefly explain your answer. (2 marks)

2017/DSE/11/12(b)

Before the British people voted against staying in the European Union (EU), i.e. Brexit, workers from the EU were free to work in Britain and vice versa. Brexit has shocked the economies in Europe and the following table shows some views on Brexit:

British politicians : Low-skilled EU workers should be required to apply for a visa to work in Britain.

British firm owners : The new visa requirement for EU workers affects most of the firms in the British economy.

Global investors : Political uncertainty in Britain increases the risk of investment projects there.

Referring to the views of the British firm owners and global investors, discuss the effect of Brexit on the aggregate output of Britain in the short run with the aid of a diagram. (8 marks)

2017/DSE/11/13(b)

To finance the scheme, there are different proposals which include:

- Proposal A: increase the standard tax rate and the progressivity of salaries tax  
Proposal B: use the fiscal reserves in the government

Discuss the effects of these two proposals on economic variables which include

- (i) aggregate output

(4 marks)

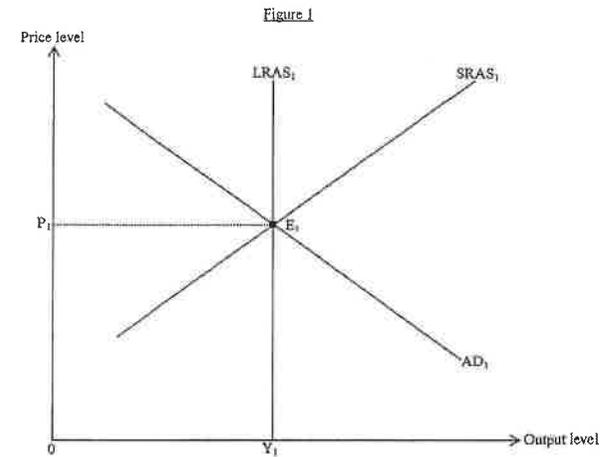
2018/DSE/11/9

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)



2018/DSE/11/11

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.

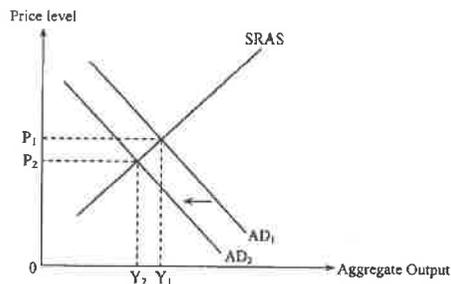
In response to the increasing military threat from Country Z, the United Nations has passed a bill to embargo most of the goods exporting from Country Z.

Analyse the effects of the above situation on Country Z's aggregate output in the short run.

(3 marks)

2013/DSE/II/12(c)

An upward adjustment of required reserve ratio reduces the money supply, resulting in an increase in interest rate and a drop in investment expenditure. (3)  
The aggregate demand will fall, and so will the price level and output level. (2)



Indicate in the diagram:

- AD shifts to the left
- price level falls
- output level falls

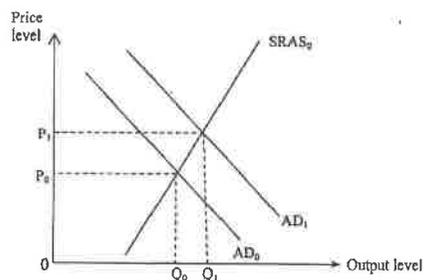
(1)  
(1)  
(1)

2014/DSE/II/10(b)

Relaxation of one-child policy would likely result in a rise in the birth rate, implying a bigger work force and a bigger aggregate supply and output in the future. (3)

2014/DSE/II/12(c)

The purchase of government bonds increases money supply, resulting in a drop in the interest rate. (2)  
Investment / consumption expenditure increases and aggregate demand increases. (2)  
In the short run, the output and price levels increases. (1)



Indicate on the diagram:

- AD curve shifts to the right
- higher price level
- higher output

(1)  
(1)  
(1)

2015/DSE/II/8

Proposal 1:

More money spent on education would increase government expenditure, leading to an increase in aggregate demand and thus aggregate output.

OR

Free education for longer years would improve labour productivity and thus aggregate output over time.

OR

Provision of free education beyond normal school age would reduce labour supply (by keeping more people at school) and thus aggregate output in the current period. (2)

Proposal 2:

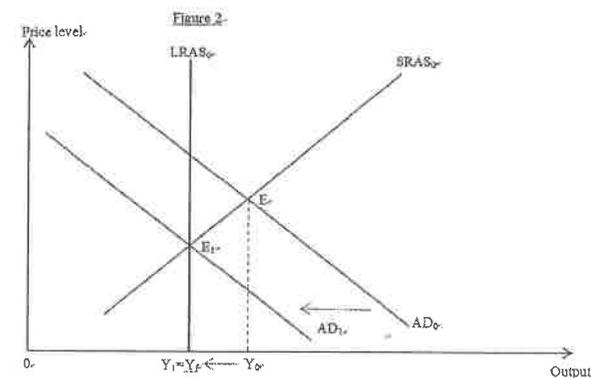
Unemployment benefits would increase the disposable income and consumption of the jobless, and thus aggregate demand, resulting in a rise in aggregate output.

OR

Unemployment benefits may, however, produce disincentive effects on labour supply, resulting in de-skilling of labour and a drop in aggregate output now and in the future. (2)

2015/DSE/II/12

(b) Export would fall, (1)  
resulting in a drop in aggregate demand, (1)  
so output would fall back to  $Y_f$ . (1)



Indicate on the diagram:

- AD curve shifts to the left
- correct position of initial short-run aggregate output  $Y_0$
- correct position of new short-run aggregate output  $Y_1 (=Y_f)$

(1)  
(1)  
(1)

(c) Hong Kong is facing an inflationary gap. (1)  
There is an excess demand in the factor market, (1)  
creating pressure for factor prices to adjust upwards, (1)  
so that costs of production would increase over time and short-run aggregate supply (SRAS) would fall over time (, restoring output to  $Y_f$  in the long run). (1)

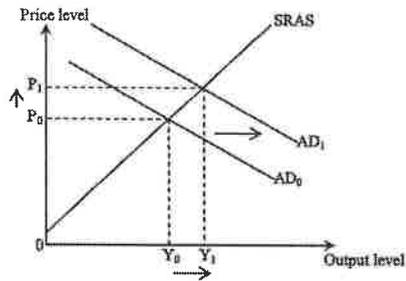
2016/DSE/II/5

When the price level increases, the adjustment of input prices is imperfect / incomplete (e.g. due to the long term contracts of factor of production), so the real cost of production -- i.e. nominal cost divided by the general price level -- will fall. Firms would thus use more factor inputs to produce larger output. Therefore, the SRAS curve is upward-sloping, i.e. a higher price level would result in a higher output level. (3)

2016/DSE/II/12(b)

The cash-sharing scheme would raise the disposable income of the residents and therefore result in an increase in consumption.

Aggregate demand would rise, raising price and output levels accordingly.



Indicate in the diagram:

- rightward shift of AD
- higher P and Y

(2)  
(2)

2017/DSE/II/9

(a) Depression / trough

(b) A reduction in interest rate would result in a rise in investment and/or consumption. Aggregate demand would thus increase, and so would aggregate output as well.

(c) Consistent. When interest rate dropped in 2009, GDP growth rate increased and unemployment rate dropped.

(d) - Subsidizing research and development  
- importation of labour  
- investment in infrastructures  
[Mark the **FIRST** policy only.]  
could increase potential output or production capacity of the economy as a whole in the long run, and thus shift LRAS rightwards.

(1)  
(1)

(1)

(1)  
(2)

(1)  
(3)

(1)

(1)

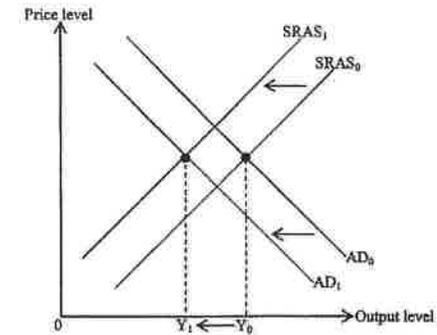
2017/DSE/II/12(b)

The new visa requirement would increase labour cost for the British firm owners, resulting in a drop in SRAS.

Political uncertainty would result in a drop in investment from the global investors and thus a fall in AD.

Aggregate output would thus fall.

(2)  
(2)  
(1)



Indicate in the diagram:

- leftward shift of AD curve
- leftward shift of SRAS curve
- lower output

(1)  
(1)  
(1)

2017/DSE/II/13(b)

Proposal A's effect on aggregate output:

An increase in salaries tax would reduce AD via a drop in disposable (after-tax) income and thus consumption. As a result, aggregate output would fall.

[An increase in salaries tax may also reduce SRAS by creating a disincentive effect on labor.]

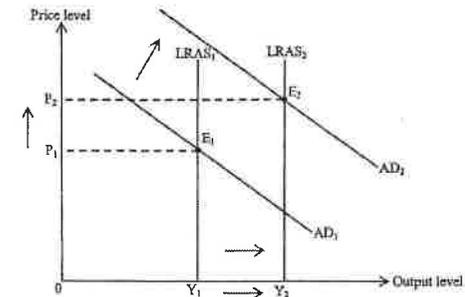
(4)

Proposal B's effect on aggregate output:

There would be no extra effect on aggregate output as a component of AD/AS does not change.

(2)

2018/DSE/II/9



Indicate in the diagram:

- rightward shift of AD (due to more visitors from the Mainland)
- rightward shift of LRAS (due to faster development of the HK economy)
- correct position of P<sub>2</sub> (at E<sub>2</sub>), with a bigger horizontal shift in AD than in LRAS

(1)  
(1)

2018/DSE/II/11

The SRAS curve would decrease, as less labour is available for production.  
The AD curve would also decrease, as the UN embargo reduces exports from Country Z.  
As a result, aggregate output would fall.

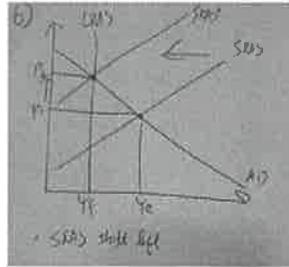
(1)  
(1)  
(1)

2018/DSE/II/13(a)(i)

Potential output would drop as the working-age population gradually decreases.  
(from 5.36M in 2014 to 4.76M in 2054)

(2)

2020/DSE/II/6



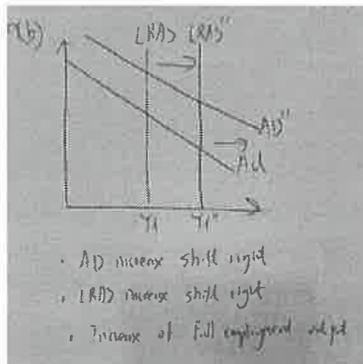
Inflationary gap exist as short run output is larger than full employment output.

Excess demand in labor market will drive up input price. ( 1 mark )

Production cost of firms increase and SRAS decrease and shift left ( 1 mark )

Short run output will decrease to full employment output level to close the inflationary gap ( 1 mark )

2020/DSE/II/9B



B) Infrastructure development will boost Government consumption expenditure ( eg. Employment of more workers ) and Gross investment expenditure ( purchase of more capital good ). Both G and I will increase the aggregate demand and the aggregate demand curve will shift rightward. ( 3 marks )

The construction of infrastructure will increase the quantity of factor endowment of an economy hence the production capacity will increase. LRAS increase and shift rightward. Full employment level will increase. ( 3 marks )

2021/DSE/II/11

(a) Deflationary (output) gap is the gap between full employment output and a lower actual output. (1)

Illustrate in the diagram:

- Current initial deflationary gap (1)

(b) Verbal elaboration:

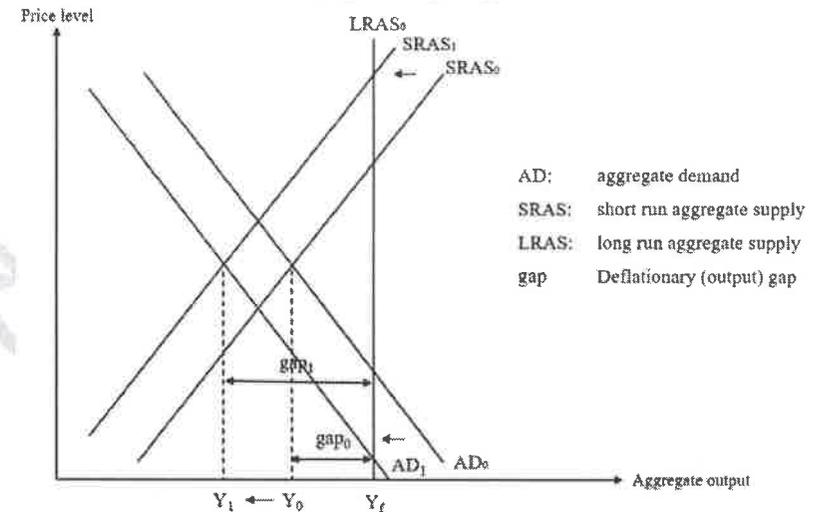
The natural disaster would lead to a temporary close down of factories, so the short run aggregate supply decreases. Many people would reduce present consumption and hence the consumption and investment expenditure decreases, aggregate demand decreases. Hence, the deflationary gap widens. (4)

Indicate in the diagram:

- AD shifts leftward (1)

- SRAS shifts leftward (1)

- Correct new Y with a larger gap (1)



(c) When the central bank carries out open market purchase of government bonds from the general public and the commercial banks, the cash held by public and reserves in banking system increases, so the deposits also increases. Holding other factor constant, the money supply will increase and the nominal interest rate will decrease. Hence, the cost of borrowing decreases and people will borrow more money for consumption and investment, aggregate demand increases and hence the deflationary gap is narrowed.

### 6.3 FISCAL BALANCE AND TRADE BALANCE

#### Multiple Choice Questions

1996/AL/II/26

If a country has a trade deficit, a rise in national income will

- A. enlarge the trade deficit.
- B. narrow the trade deficit.
- C. achieve an equilibrium in its balance of payments.
- D. increase the value of net exports.

2003/AL/II/26

Which of the following can explain the co-existence of unemployment, budget deficit and trade deficit?

- A. a fall in consumption expenditure
- B. a fall in investment expenditure
- C. a fall in exports
- D. a fall in government expenditure

2012/DSE/I/31

In an open economy, the government expenditure is equal to tax revenue and the value of exports is equal to the value of imports. If there is an increase in private consumption expenditure, the government will have \_\_\_\_\_ and there will be \_\_\_\_\_

- A. a budget deficit ..... a trade deficit
- B. a budget deficit ..... a trade surplus
- C. a budget surplus ..... a trade deficit
- D. a budget surplus ..... a trade surplus

2013/DSE/I/31

Initially an economy operates at the full-employment equilibrium and the government expenditure equals its tax revenue. Which of the following will result in a coexistence of deflationary (output) gap and budget deficit?

- A. a reduction in taxes
- B. a reduction in money supply
- C. a reduction in government expenditure
- D. a reduction in desire to import

2016/DSE/I/39

Suppose Country A initially operates at the full-employment equilibrium and the fiscal budget of the government is balanced. In the short run, an economic recovery of Country A's trading partners will result in \_\_\_\_\_ and \_\_\_\_\_ of Country A.

- A. an inflationary (output) gap ..... a fiscal surplus
- B. an inflationary (output) gap ..... a fiscal deficit
- C. a deflationary (output) gap ..... a fiscal surplus
- D. a deflationary (output) gap ..... a fiscal deficit

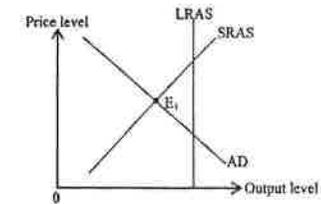
2016/DSE/I/40

Under which of the following situations may a fiscal deficit and a trade deficit be eliminated at the same time?

- (1) a decrease in nominal interest rate
  - (2) a depreciation of the economy's currency
  - (3) an increase in income tax
- A. (1) and (2) only
  - B. (1) and (3) only
  - C. (2) and (3) only
  - D. (1), (2) and (3)

2017/DSE/I/39

The diagram below shows the aggregate demand curve, the short run aggregate supply curve and the long run aggregate supply curve of an economy.



Suppose the economy initially operates at  $E_1$  and the total import value equals total export value. If the government decreases the social security assistance to the elderly, in short run, the deflationary (output) gap will be \_\_\_\_\_ and there will be a \_\_\_\_\_

- A. narrower ..... trade surplus
- B. wider ..... trade deficit
- C. narrower ..... trade deficit
- D. wider ..... trade surplus

2018/DSE/I/36

Suppose a deflationary (output) gap and a fiscal deficit exist in a country. Which of the following would narrow the deflationary (output) gap and reduce the fiscal deficit at the same time?

- A. increasing government expenditure on infrastructure
- B. reducing the profits tax rate
- C. increasing the tax rebate on salaries tax
- D. allowing more tourists to travel to the country visa-free

2019/DSE/I/40

Suppose an inflationary (output) gap and a fiscal surplus exist in an economy. Which of the following measures would help narrow the inflationary (output) gap and attain a balanced fiscal condition at the same time?

- A. reducing quota for inbound tourists
- B. raising income tax rate
- C. adopting a universal retirement protection scheme for all elderly aged 65 or above
- D. increasing government spending on infrastructure

2021/DSE/1/29

The outbreak of COVID-19 results in a significant decline in employment level and the volume of exports of a country.

Which of the following policies can most likely relieve the above two problems?

- A. The central bank reduces the discount rate.
- B. The government distributes cash to citizens aged 18 years old or above.
- C. The government imposes 'employment support scheme' to industries that are adversely affected.
- D. The country devalues its currency against the currencies of its major trading partners.

2021/DSE/1/37

Which of the following policies may narrow a deflationary (output) gap and reduce the budget deficit at the same time?

- A. an open market purchase of government bonds
- B. an increase in income tax allowance
- C. a reduction in transfer payment
- D. an increase in required reserve ratio

Short & Structured Questions

2002/AL/11/6

Suppose the Hong Kong economy was initially in full employment with a fiscal budget balance and a trade balance. The economy is currently suffering from problems of unemployment and the 'twin deficits' (i.e., the coexistence of trade deficits and fiscal deficits).

- (a) Three explanations, all of which involve a reduction in autonomous spending, have been proposed: (i) a fall in private consumption, (ii) a fall in private investment, (iii) a fall in exports. Evaluate the ability of each of these factors to explain the coexistence of unemployment and the twin deficits. (6 marks)
- (b) As a fourth possibility, is a fall in government expenditure a valid explanation for these three problems? To balance its budget, the government has to find ways to increase its revenue and/or cut its expenditure. Will such fiscal actions help resolve the unemployment and trade deficits problems simultaneously? If not, how will unemployment and trade deficits be affected by such actions? (4 marks)

2006/AL/11/6(a)(i)

A country running trade deficits against the rest of the world can deal with the problem by either expenditure-reducing policies or expenditure-switching policies. The former involves the use of contractionary fiscal and/or monetary policies to reduce overall (including import) expenditure; while the latter involves the use of exchange-rate and/or protectionist policies to switch expenditure away from foreign goods and/or toward domestic goods.

An example of expenditure-reducing policies is to increase income taxes. Explain without using any graphs and economic models why raising the income tax rate can help improve the trade balance. (2 marks)

MARKING SCHEME

1996/AL/II/26 A	2012/DSE/I/31 C (40%)	2016/DSE/I/39 A (69%)	2017/DSE/I/39 D (51%)	2019/DSE/I/40 A
2003/AL/II/26 C	2013/DSE/I/31 B (45%)	2016/DSE/I/40 C (34%)	2018/DSE/I/36 D (62%)	2021/DSE/I/29 D
2021/DSE/I/37 A				

2002/AL/II/6

(a) The 3<sup>rd</sup> explanation, fall in exports, can be a common cause of unemployment and the twin deficits.

$X \downarrow \Rightarrow AD \downarrow \Rightarrow$

$Y \downarrow \Rightarrow$  [Effect 1:] unemployment

$Y \downarrow \Rightarrow$  [Effect 2:] tax revenue  $\downarrow \Rightarrow$  fiscal deficit

$Y \downarrow \Rightarrow$  [Effect 3:] imports  $\downarrow \Rightarrow$  trade deficit

[since the effect of  $\Delta X$  on  $NX$  is bigger than its effect through  $\Delta M$ , i.e.  $X \downarrow > M \downarrow$ ]

*Note: For a given size of the workforce, an increase in unemployment implies a decrease in labour employment, which implies in turn a decrease in output (Y), given the production technology and other factors of production.*

(b) Fiscal contraction has the following consequences:

$G \downarrow$  and  $T \uparrow \Rightarrow AD \downarrow \Rightarrow$

$Y \downarrow \Rightarrow$  [Effect 1:] unemployment

$Y \downarrow \Rightarrow$  [Effect 2:] tax revenue  $\downarrow$  but fiscal balance still  $\uparrow$

[because the effect of  $\Delta G$  on  $(T - G)$  is bigger than its effect through  $\Delta T$ , i.e.  $G \downarrow > T \downarrow$ ]

$Y \downarrow \Rightarrow$  [Effect 3:] imports  $\downarrow \Rightarrow$  trade balance  $\uparrow$

(No.) this single stone can at best kill two birds, but not all three.

2006/AL/II/6(a)(i)

Income taxes as expenditure-reducing policy

Income tax rate  $\uparrow$

$\Rightarrow$  disposable income  $\downarrow$

$\Rightarrow$  consumption demand and import expenditure  $\downarrow$

$\Rightarrow$  improvement in trade balance (given exports)

SECTION 7: INTERNATIONAL TRADE

7.1: GAINS FROM FREE TRADE

Multiple Choice Questions

1996/AL/II/6

Autarky, which forms trade barriers,

- A. maintains potential for specialization and
- B. encourages growth increases.
- C. is superior to free trade exports.
- D. is necessary to producing goods in which country has absolute advantage.

2002/AL/II/6

The table below shows the production of two goods in two countries

Country	One unit of homogeneous products	
	Good X (units)	Good Y (units)
Country A	10	5
Country B	5	10

Suppose there are no barriers to trade between the two countries.

- A. X will export and Y will import.
- B. X will export and Y will import from Y.
- C. Y will export and X will import from Y.
- D. neither country will benefit from free trade.

2006/AL/II/6

The following table shows the number of man-hours required for the production of two goods X and Y in Country A and B.

	Country A	Country B
1 unit of X	2 man-hours	3 man-hours
1 unit of Y	3 man-hours	2 man-hours

According to the principle of comparative advantage,

- A. Country A will export X and import Y.
- B. Country A will export X and import Y.
- C. Country A will import X and Y from Country B.
- D. Country A will export X and Y to Country B.