

Unit – 5

National Income and Balance of Trade

National Income – Meaning

National income refers to the total income earned by the normal residents of a country from their economic activities during a particular period, usually one year. It includes income earned from agriculture, industry, trade, transport, banking and other services. National income helps to understand the overall economic performance of a country. For example, if the income earned from agriculture is ₹20 lakh, industry is ₹30 lakh and services is ₹50 lakh, the total income generated is ₹100 lakh.

Concepts:

1. Gross Domestic Product (GDP)

Gross Domestic Product (GDP) is the total monetary value of all final goods and services produced within the geographical boundaries of a country during a particular year. GDP considers the location of production, irrespective of whether the producer is a domestic or foreign company. For example, if a Japanese company produces goods worth ₹50 crore in India, this production is included in India's GDP because the production takes place within India. GDP can be expressed as $GDP = C + I + G + (X - M)$.

2. Gross National Product (GNP)

Gross National Product (GNP) refers to the total monetary value of final goods and services produced by the normal residents of a country during a particular year, whether the production takes place within the country or abroad. GNP is calculated by adding Net Factor Income from Abroad to GDP. For example, if India's GDP is ₹1,000 crore, Indians earn ₹100 crore from abroad and foreigners earn ₹60 crore in India, the Net Factor Income from Abroad is ₹40 crore. Therefore, India's GNP is ₹1,040 crore.

3. Net National Product (NNP)

Net National Product (NNP) is the value obtained after deducting depreciation from Gross National Product. Depreciation refers to the reduction in the value of fixed assets such as machinery, buildings and equipment due to regular use, wear and tear or obsolescence. The formula is $NNP = GNP - \text{Depreciation}$. For example, if GNP is ₹1,000 crore and depreciation is ₹100 crore, NNP will be ₹900 crore.

4. Per Capita Income

Per capita income means the average income earned by each person in a country. It is calculated by dividing national income by the total population. The formula is $\text{Per Capita Income} = \text{National Income} \div \text{Population}$. For example, if the national income is ₹10,000 crore and the population is 100 crore, the per capita income is ₹100 per person. Per capita income is useful for understanding average income levels and comparing economic conditions over time or between countries.

Measurement of National Income

National income can be measured by three important methods. They are Product Method, Income Method and Expenditure Method. These methods calculate national income from different sides of economic activity. Ideally, all three methods should give the same result.

1. Product Method

The Product Method is one of the methods used to measure national income. Under this method, the value of final goods and services produced by different sectors of the economy during a year is calculated. The major sectors include agriculture, industry and services. For example, if agriculture produces goods worth ₹200 crore, industry ₹300 crore and services ₹500 crore, the total output is ₹1,000 crore. Only final goods and services are considered to avoid double counting.

2. Income Method

The Income Method measures national income by adding the incomes earned by the factors of production. The major factor incomes are wages, rent, interest and profit. For example, if workers receive ₹400 crore as wages, landowners receive ₹100 crore as rent, capital owners receive ₹150 crore as interest and entrepreneurs earn ₹250 crore as profit, the total factor income will be ₹900 crore.

3. Expenditure Method

The Expenditure Method measures national income by calculating the total expenditure made on final goods and services during a particular period. It includes private consumption expenditure, investment expenditure, government expenditure and net exports. The formula is $Y = C + I + G + (X - M)$. For example, if consumption is ₹500 crore, investment is ₹200 crore, government expenditure is ₹150 crore, exports are ₹100 crore and imports are ₹50 crore, total expenditure is ₹900 crore.

Difficulties in Measurement of National Income

Measuring national income is not an easy task, especially in developing countries. Several practical difficulties make the accurate estimation of national income challenging.

1. Double Counting

Double counting means counting the value of the same good or service more than once while calculating national income. It may happen when both **intermediate goods and final goods** are included.

Example: Wheat → Flour → Bread.
If the value of wheat, flour and bread is added separately, the same value is counted more than once. Therefore, only the **value of final goods** or **value added at each stage** should be included.

2. Non-Monetary Transactions

Some economic activities do not involve **money transactions**. For example, farmers may consume part of the crops they produce themselves, or people may exchange goods through barter. Since there is no actual money transaction, it is difficult to measure their value accurately.

Example:

A farmer produces rice and consumes some of it at home. This production has economic value, but no money is received for it.

3. Lack of Proper Records

In many countries, particularly in the **unorganised sector**, proper accounts and records may not be maintained. Small traders, farmers, household businesses and self-employed persons may not keep accurate records of their income and production.

Example:

A small shopkeeper may not maintain complete records of daily sales and expenses. Therefore, estimating the actual income becomes difficult.

4. Unpaid Services

Many useful services are performed **without monetary payment** and are therefore difficult to include in national income.

Example:

A homemaker cooking food, cleaning the house and taking care of children provides valuable services, but these services are generally not included in national income because no money is paid for them.

5. Price Changes

Changes in the **general price level** create difficulties in measuring national income. An increase in the value of national income may be due to higher prices rather than an actual increase in the quantity of goods and services produced.

Example:

If the value of production increases from ₹10 lakh to ₹12 lakh only because prices have increased, it does not necessarily mean that real production has increased.

6. Depreciation

Depreciation refers to the reduction in the value of fixed assets such as machinery, buildings and vehicles due to **wear and tear, age and obsolescence**. It is difficult to estimate the exact amount of depreciation, especially when assets are used for many years.

Example:

A machine purchased for ₹10 lakh may lose part of its value every year due to use. Estimating its exact annual depreciation is necessary for calculating **net national income**.

Business Cycle

A business cycle refers to the periodic fluctuations in economic activities such as production, income, employment, investment and prices. Economic activities do not remain at the same level throughout the year. They move through different stages of expansion, peak, recession and recovery. For example, when demand for automobiles increases, automobile companies may increase production and employ more workers. When demand falls, production and employment may decline.

Various Phases of Business Cycle

A **Business Cycle** refers to the regular fluctuations in economic activities such as production, income, employment, investment and sales over a period of time. It generally passes through **four main phases: Expansion, Peak, Recession and Recovery.**

1. Expansion

Expansion is the phase in which economic activities increase. Production, income, employment, investment and consumer spending rise. Businesses receive more orders and earn higher profits. New businesses may also be started during this period.

Example:

When demand for cars increases, automobile companies increase production and hire more workers. This leads to higher income and employment.

2. Peak

The **Peak** is the highest point of the business cycle. During this phase, economic activity reaches its maximum level. Production, employment, income and demand are generally very high. However, prices and costs may also increase.

Example:

A company may operate at full production capacity because demand is very high and there are very few unemployed workers.

3. Recession

Recession is the phase in which economic activity begins to decline from the peak. Production, sales, investment, income and employment decrease. Businesses may reduce production because demand falls.

Example:

If consumers reduce their purchases, companies may receive fewer orders and reduce production and working hours.

4. Recovery

Recovery is the phase in which economic activity starts improving after a recession. Production, employment, income, investment and demand gradually increase. Businesses become more confident and begin increasing their activities.

Example:

When consumer demand starts increasing again, companies increase production and hire more workers.

Important Implications of Business Cycles for Business

Business cycles have a significant impact on business activities. Changes in economic conditions affect **production, employment, investment, profit and business decisions**.

1. Impact on Production

Business cycles directly affect the level of production. During the **expansion phase**, demand increases, so businesses increase production. During **recession**, demand decreases and businesses may reduce their production.

Example:

If demand for clothing increases, textile companies may increase production. If demand falls, they may reduce production.

2. Impact on Employment

Business cycles affect the level of **employment and unemployment**. During expansion, businesses require more workers and employment increases. During recession, businesses may reduce working hours, stop recruitment or reduce the workforce.

Example:

A growing company may hire 20 new workers to meet increased demand, while a company facing falling sales may reduce its workforce.

3. Impact on Investment

Business cycles influence business **investment decisions**. During expansion, businesses are more willing to invest in new machinery, buildings and technology because demand and profits are expected to be higher. During recession, businesses may postpone or reduce investment.

Example:

A manufacturing company may purchase new machinery when sales are increasing but postpone the purchase when demand is falling.

4. Impact on Profit

Business cycles have a direct effect on **business profits**. During expansion, higher sales and production can increase profits. During recession, falling demand and sales can reduce profits and may even lead to losses.

Example:

If a company's sales increase from ₹10 lakh to ₹15 lakh during expansion, its profit may also increase. During recession, reduced sales may lower its profit.

5. Impact on Business Decisions

Business cycles influence important **business decisions** relating to production, pricing, investment, employment, inventory and expansion. Managers need to consider the current economic situation before making major decisions.

Example:

During an economic slowdown, a business may control costs and reduce inventory. During expansion, it may increase production and open new branches.

Balance of Trade and Balance of Payments

Balance of Trade

1. Meaning of Balance of Trade

Balance of Trade (BOT) refers to the difference between the value of exports and imports of goods of a country during a particular period, usually one year. It includes only **visible items**, such as machinery, food products, textiles, petroleum and other physical goods.

Formula:

Balance of Trade = Value of Exports of Goods – Value of Imports of Goods

Example:

If a country exports goods worth ₹500 crore and imports goods worth ₹400 crore:

$BOT = ₹500 \text{ crore} - ₹400 \text{ crore} = ₹100 \text{ crore surplus}$

2. Favourable Balance of Trade

A favourable balance of trade occurs when the value of exports of goods is greater than the value of imports of goods. It is also called a trade surplus.

Example:

Exports	=	₹800	crore
Imports	=	₹600	crore

$BOT = ₹200 \text{ crore surplus.}$

3. Unfavourable Balance of Trade

An **unfavourable balance of trade** occurs when the **value of imports of goods is greater than the value of exports of goods**. It is also called a **trade deficit**.

Example:

Exports	=	₹600	crore
Imports	=	₹800	crore

$BOT = ₹200 \text{ crore deficit.}$

4. Balanced Trade

Balanced trade occurs when the **value of exports of goods is equal to the value of imports of goods**.

Example:

Exports	=	₹500	crore
Imports	=	₹500	crore
BOT = Zero			

Simple Summary

Type	Condition
Favourable BOT	Exports > Imports
Unfavourable BOT	Imports > Exports
Balanced Trade	Exports = Imports

Balance of Payments

1. Meaning of Balance of Payments

Balance of Payments (BOP) is a systematic record of all economic transactions between the residents of a country and the rest of the world during a particular period, usually one year.

Unlike Balance of Trade, BOP covers goods, services, income, transfers and financial transactions.

Example:

Exports and imports of goods, tourism services, foreign investment, foreign loans and remittances are recorded in the Balance of Payments.

2. Current Account

The **Current Account** records transactions relating to **goods, services, primary income and secondary income** between a country and other countries.

It mainly includes:

1. **Exports and imports of goods**
2. **Services** such as tourism, banking and transportation
3. **Primary income** such as interest, profits and dividends
4. **Secondary income** such as remittances and transfers

Example:

When an Indian company exports software services to a foreign customer, the transaction is recorded in the current account.

3. Capital and Financial Transactions

The **capital and financial account** records transactions involving **capital transfers and financial assets and liabilities** between a country and the rest of the world.

It includes transactions such as:

- Foreign Direct Investment (FDI)
- Portfolio investment
- Foreign loans
- Banking and other financial transactions
- Changes in foreign assets and liabilities

Example:

If a foreign company invests ₹100 crore in an Indian manufacturing company, the investment is recorded as a financial transaction in the BOP.

4. Importance of Balance of Payments

Balance of Payments is important because it provides information about a country's **economic relationship with the rest of the world**.

1. Measures International Transactions

It shows the country's transactions with other countries.

2. Helps in Economic Planning

The government uses BOP information while making **trade, monetary and economic policies**.

3. Shows Foreign Exchange Position

It provides information about the country's **foreign exchange earnings and payments**.

4. Helps to Identify External Imbalances

BOP helps identify problems such as **persistent current account deficits or shortages of foreign exchange**.

5. Helps Business Decisions

Businesses can use information about international trade and financial flows when making decisions about **exports, imports and foreign investment**.

Balance of Trade vs Balance of Payments

Basis	Balance of Trade	Balance of Payments
Meaning	Difference between exports and imports of goods	Record of economic transactions with the rest of the world
Coverage	Mainly goods	Goods, services, income, transfers and financial transactions
Scope	Narrow	Broad
Main Components	Exports and imports of goods	Current account and capital/financial transactions
Purpose	Shows trade position in goods	Shows overall external economic position

Current Situation and Future Prospects of International Trade

Current Situation of International Trade

International trade plays an important role in the Indian economy. India trades with many countries and exports a wide range of goods and services. Recent data from the Ministry of Commerce shows that India has **more than 200 trading partners** and trades in thousands of commodity categories.

1. India's Major Exports

India exports both **goods and services** to international markets. Major merchandise export groups include **petroleum products, electronic goods, drugs and pharmaceuticals, and engineering goods**. Other important exports include textiles and garments, chemicals, agricultural products, automobiles and auto components.

Example:

India exports medicines, petroleum products, engineering goods and electronic products to countries such as the **United States, United Arab Emirates, Netherlands and United Kingdom**.

2. India's Major Imports

India imports goods that are required for **energy, production, technology and consumption**. Major imports include **crude petroleum, gold, electronic goods, petroleum products, coal and machinery**. Recent Department of Commerce data identifies petroleum, gold and electronic goods among the major import categories.

Example:

India imports crude oil for energy requirements and electronic components for manufacturing and technology-related activities.

3. Role of Foreign Trade

Foreign trade contributes to **economic growth and development** by providing markets for Indian products and allowing businesses to obtain goods, raw materials and technology from other countries. It also helps businesses reach international customers and encourages investment and industrial development.

Example:

An Indian textile company can sell garments to customers in foreign countries, thereby increasing its market and earning foreign exchange.

Future Prospects of International Trade

1. Export Promotion

India can increase exports by improving **product quality, infrastructure, technology, packaging and international marketing**. Promoting value-added products can also help Indian businesses compete in international markets.

Example:

Instead of exporting raw agricultural products, businesses can export processed and packaged food products.

2. Foreign Exchange Earnings

Exports generate **foreign exchange earnings**, which can be used to pay for imports and international financial obligations. Increasing exports can therefore strengthen India's external economic position.

Example:

When an Indian company exports software services and receives payment in foreign currency, it contributes to foreign exchange earnings.

3. Employment Opportunities

Expansion of international trade can create employment in **manufacturing, agriculture, transport, logistics, banking, information technology and export-related services**.

Example:

Growth in garment exports can create employment in textile factories, packaging, transportation and shipping.

4. Technology and Investment

International trade can encourage the flow of **modern technology, foreign investment, skills and management practices**. Foreign investment can also support the development of new industries and production facilities.

Example:

A foreign company investing in an Indian electronics factory may bring modern machinery and production technology.

5. International Market Expansion

International trade provides Indian businesses with opportunities to **enter new markets and increase their customer base**. Government trade agreements and improved logistics can help businesses reach more countries.

Example:

An Indian food-processing company that previously sold only in India can expand its sales to markets in the Middle East, Europe or Southeast Asia.