

Emerging Trends in Exchange Rate Volatility, Trade Performances and Exporters' Profitability

April 2012



PHD RESEARCH BUREAU

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Sandip Somany
President
PHD Chamber

Foreword

The global economic situation is extremely volatile at this stage with the onset of the Euro-zone crisis and its intensification across the advanced world. This global economic slowdown has caused rampant volatility in the stock markets across various developing economies. Many of the emerging markets have witnessed large capital outflows, leading to unstable currency exchange rates. Most BRICS economies have undergone currency depreciation, coinciding with the world financial market conditions. This situation, exchange rates being a lead indicator, could have serious implications for world trade.

Though in the economies like India, the exchange rates have depreciated significantly, in the wake of these global developments, Indian economy has remained resilient to the fluctuations, which is evident from its economic performance in the Post-Lehman crisis period. The average economic growth has remained above 7% during the last four years (FY2009-FY2012) Research has shown that these short term volatility in exchange rates of rupee have not had significant impact on India's trade situation or the profits of export oriented industries as it has been caused due to world economic instability and not India's economic fundamentals.

This study further throws light on the fact that contrary to the common notion that depreciation of rupee would boost trade performances, it does not have any significant impact on them. It is in fact the global economic condition which determines pattern of trade. However, it is suggested that, operating in a country which is highly open and integrating with the global economy, the industry should be prepared for such disturbances which are caused due to external shocks from time to time.

Sandip Somany



Susmita Shekhar
Secretary General
PHD Chamber

Preface

Emerging trends in exchange rate volatility, trade performances and exporters' profitability has been prepared with the objective to study the impact of exchange rate volatility on trade and industry and it gives me immense pleasure and honour to present it to our esteemed readers. It is an exhaustive empirical report on the rupee's exchange rate movement in the wake of India's increasing global integratedness and its impact on India's exports, profitability and overall economic performance.

Rupee has depreciated significantly against the dollar in the recent months in the wake of current global economic slowdown. However, empirical analysis has revealed that weak rupee may not have any significant impact on the exports, trade balances, profits in case of India. This paper attempts to study the emerging trends in exchange rate volatility, trade performances and profitability, in the past few years.

I commend and appreciate the efforts of PHD Research Bureau which has come up with this report with its focused approach. I hope that this study will add to the existing literature in this subject and enhance the horizons for further research in this area.

Susmita Shekhar

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Abbreviations

Bn	Billion
BRICS	Brazil, Russia, India, China, South Africa
FII	Foreign Institutional Investments
FY	Financial Year
GDP	Gross Domestic Product
GSDP	Gross State Domestic Product
INR	Indian National Rupee
LERMS	Liberalized Exchange Rate Management System
Mn	Million
US	United States

Abstract

Rupee has depreciated significantly against the dollar in the recent months in the wake of current global economic slowdown. Contrary to the common perception which indicates that a weak rupee helps to improve trade performances, empirical evidence on several indicators like exports, trade balances, profits have shown that rupee appreciation/ depreciation does not have any significant impact on them. It is in fact the global demand condition which ultimately impacts the trade and profitability scenario of exporters in India. This paper attempts to study the emerging trends in exchange rate volatility, trade performances and profitability, in the past few years.

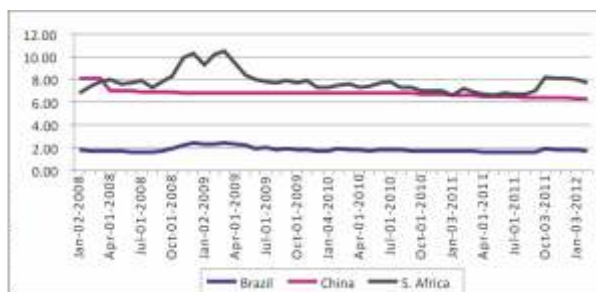
Expanding exchange rate trajectory

The world economic environment is extremely volatile at this stage which has the potential of disruptive consequences for all the economies around the globe. The sovereign debt problems that have beset the euro area over the past year, are now threatening the larger economies of the region. Most of the advanced economies are caught up in the quagmire of unemployment, high debt and fiscal deficit. Advanced economies' attempts to fight these problems have caused extremely volatile financial markets across the globe.

The currencies of many emerging and developing economies suffered large depreciations with the onset of the global financial crisis. Collapsing trade and financial flows led to substantial balance of payments gaps, triggering fast depreciations and higher exchange rate volatility in recent times. The exchange rate losses varied largely commensurate with the extent and nature of each country's exposure to trade and global financial markets. Most of the BRICS economies have undergone depreciation during 2011 and have shown significant volatility, coinciding with the world economic and financial conditions.

Trend in exchange rates across BRICS countries

Brazil, China & South Africa



Russia & India



Source: PHD Research Bureau, compiled from various

The Lehman crisis period (2008-09) saw extreme volatility with regards to currency fluctuations amongst various emerging economies driven by uneven capital flows. Though the exchange rates rebounded during the recovery period, however, they depreciated sharply again with the re-emergence of Euro-zone crisis since beginning of 2011. It was found that South African Rand depreciated the maximum during 2011 by -22% from its value during the beginning of the year. The percentage of variation between its lowest and highest mark was around -30% during 2011.

This is followed by Indian Rupee, Brazilian Real and Russian Ruble which depreciated by around -18.5%, -13% and -5.4% during 2011, with its percentage variation between lowest and highest point at -22%, -23% and -20% respectively. However, Chinese Yuan has remained more or less stable and shown an appreciation of 4.5% and the maximum variation ranging to -5.3% during 2011.

Exchange rate volatility among BRICS countries against US\$ during 2011

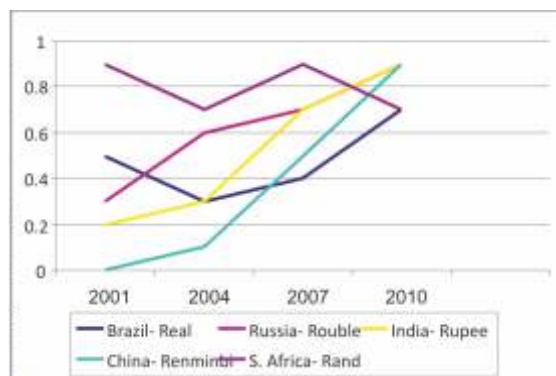
Country	3rd Jan 2011	30th Dec 2011 on 30 Dec 2011 vis-à-vis 1 Jan 2011	Depreciation/ Appreciation	Low	High	Difference from low to high	Volatility (%) in exchange rate from low to high
Brazil BRL	1.65	1.87	-12.89	1.54	1.89	-0.35	-23.01
Russia RUB	30.56	32.21	-5.40	27.33	32.78	-5.45	-19.95
India INR	44.77	53.07	-18.53	44.07	53.64	-9.57	-21.71
China CNY	6.60	6.30	4.52	6.30	6.64	-0.34	-5.33
S. Africa ZAR	6.63	8.10	-22.11	6.59	8.54	-1.95	-29.65

Source: PHD Research Bureau, compiled from various

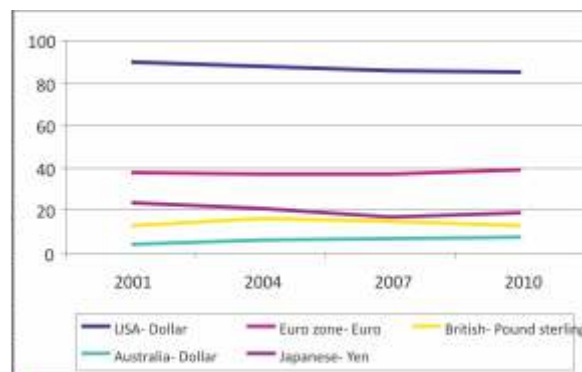
The share of BRICS currencies in global currency turnover has mostly shown an upward trend during the last 10 years, indicating expanding global integratedness in the economies. Brazilian Real and Chinese Renminbi have shown robust growth in their shares growing from 0.4% in 2007 to 0.7% in 2010 and 0.5% in 2007 to 0.9% in 2010, respectively. The share of Russian Ruble and Indian Rupee have also kept up the steady trend and have grown from 0.7% to 0.9% during the period while South African Rand's share has declined marginally from 0.9% to 0.7% during the period.

The share of the currencies in the advanced economies however, has shown a stagnating trend. The share of US dollar and British Pound has been falling in overall currency turnover, while the share of Euro, Australian Dollar and Japanese Yen has remained stagnant over the last 10 years.

Share of BRICS in global currency turnover



Share of advanced economies in global currency turnover



Source: PHD Research Bureau, compiled from Triennial Central Bank Survey, Bank for International Settlements

1. Rupee trade trajectory vis-à-vis trade volumes

It may be mentioned that the structure of Indian economy underwent a major change during the 2000s period in terms of openness. The openness of Indian economy has been increased rapidly during this period. If the trade flows into the country are considered alongside capital flows, the rise in global openness (measured as current receipts and payments plus capital receipts and payments) was extremely significant from 52% of GDP during 2002-04 to 81% in 2005-07 to 108% during 2008-10.

India's global openness, exchange rate trajectory & trade volume of rupee

Year	Global Openness*	Rupee exchange rate trajectory against US\$	Trade Volume of INR (US\$Mn)
2002-2004	54.16	5.75 (43.29-49.04)	6066
2005-2007	80.98	7.74 (39.1-46.84)	21130
2008-2010	108.43	12.83 (39.13-51.96)	33936

Source: PHD Research Bureau, compiled from Triennial Central Bank Survey, Bank for International Settlements

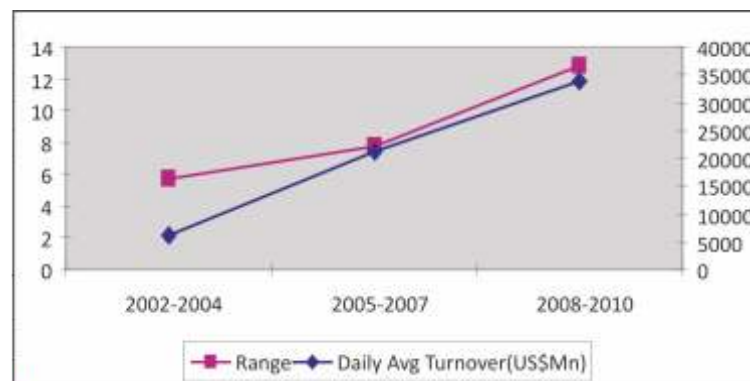
Note: *Sum of current receipts and payments + sum of capital receipts and payments as a percentage of nominal GDP

Amount in parenthesis refers to the difference between the highest and the lowest exchange rate of US\$ against Indian rupee during the corresponding period.

Trade Volume of INR (US\$Mn) indicates the daily averages turnover of Indian rupee in US\$ during April 2004, 2007 and 2010.

With rise in global openness, the trade trajectory and trading volumes of rupee have also enlarged manifold. The differences in three yearly lowest and highest exchange rate of rupee against the dollar during 2002-04 to 2008-10 showed that as the daily average rupee turnover increased from US\$6066mn in 2002-04 to US\$21130mn in 2005-07 to US\$33936mn in 2008-10, the gap between the lowest and highest mark in rupee increased from 5.75 basis points to 7.74 basis points, to 12.83 basis points in the respective periods.

Trend in variation in rupee against US\$ vis-à-vis turnover in rupee trade



Source: PHD Research Bureau compiled from Triennial Central Bank Survey, Bank for International Settlements

Left Y axis indicates the range, range refers to the difference between the highest and the lowest exchange rate of US\$ against Indian rupee during the corresponding period.

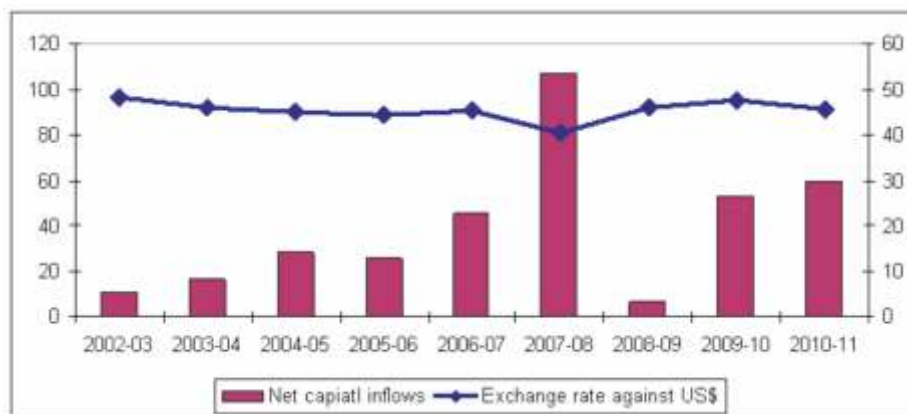
Right Y indicates the daily averages turnover of Indian rupee in US\$ during April 2004, 2007 and 2010.

2. Rupee vis-à-vis capital flows in India

With the opening up of the economy during 1990 reforms, India moved away from the pegged exchange rate to the Liberalized Exchange Rate Management System (LERMS) in 1992 and the market determined exchange rate regime in 1993 which is considered as an important structural change in the exchange rate market. Since then, the exchange rates of rupee against all foreign exchanges have been determined by the free market forces. However, this increased global integratedness has increasingly exposed the economy to world macro-economic environment.

This has also enhanced the exposure to international capital flows vis-à-vis increased capital and current account transactions. The recent behaviour of exchange rate and capital flows suggest that the exchange rate scenario is significantly impacted by capital flows. It is reflected from the fact that the currency appreciated significantly in 2007-08 when the capital inflows were very high and depreciated considerably in 2009-10 vis-à-vis low capital inflows on account global economic slowdown.

Net capital inflows (in US\$ bn) vis-à-vis exchange rate of rupee (against US\$)



Source: PHD Research Bureau, compiled from RBI

Left y axis stands for Net capital inflows; right y axis stands for exchange rate of Rupee against US\$

Following the sovereign debt crisis across the advanced world in 2011, the Indian rupee has witnessed sharp depreciation. This has occurred on account of significant strengthening of dollar against the euro and consequently other currencies in the world. With intensifying of the euro-zone crisis, since October 2011, it has been observed that the euro has been declining steadily against the dollar. It is striking to note that the movement of the rupee against dollar has been synchronized with the former, leading to considerable depreciation of the rupee against dollar during that time.

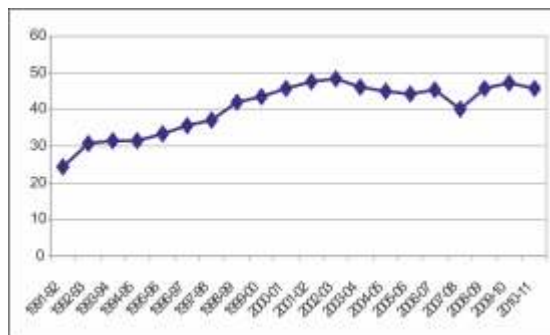
Trend in Euro/ US\$ vis-à-vis Rupee/ US\$ since 2011



Source: PHD Research Bureau, compiled from various sources

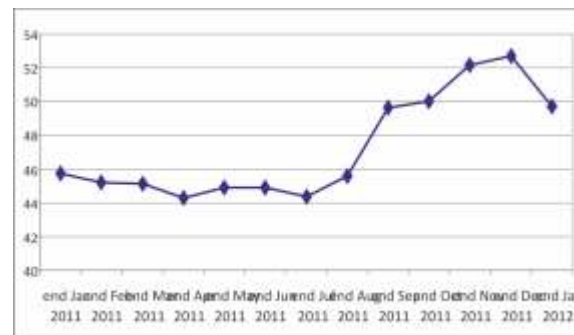
However, of late, with the rebound in stock markets, vis-à-vis capital flows, the continuous depreciation of rupee seems to have met with some moderation in January to February 2012 with the rupee coming back to its Rs.49-50/ US\$ trajectory.

Long term trend in rupee against US\$



Source: PHD Research Bureau, compiled from RBI

Trend in exchange rate of rupee against US\$ (2011)



Though, over all capital inflow/ outflow impact the rupee scenario, it has been observed that FII inflows in stock market have emerged as a significant exchange rate driver in the short run or on a day to day basis. It was found that change in exchange rate of rupee is positively correlated to stock markets and FII investments. Stock markets in turn is highly correlated with FII investments, whereas, exchange rates are positively correlated with volume of currency future and options traded.

Bilateral correlation of financial indicators

Bilateral Correlations		Correlation Coefficients	Outcome
Change in exchange rate* (INR/US\$)	Stock Market^	0.31	Positive correlation
FII Investments**	Stock Market^	0.65	High degree of Positive correlation
Change in exchange rate* (INR/US\$)	FII Investments **	0.19	Positive Correlation

Source: PHD Research Bureau compiled from RBI, BSE, NSE and SEBI

Note: *The data pertains to average exchange rates for INR/US\$ as per calendar year. The absolute change in exchange rates from 1993 to 2012 have been taken i.e. In 1993 the exchange rate of INR/US\$ (average) is 31.44 and in 1994 the exchange rate of INR/US\$ (average) is 31.37 so, the absolute difference 0.07 has been taken and applied for the subsequent years also. Thus, the absolute differences have been taken to find the correlation with different financial indicators.

**The FII investments pertains to Net FII investments in US\$ million since 1993 to 2012.

^ The closing BSE Sensex statistics have been taken to find the absolute change. The absolute change in BSE Sensex(close) from 1993 to 2012 have been taken i.e. in 1993 the sensex closed at 3346.06 and in 1994 the sensex closed at 3926.9 and the absolute change has been taken at 580.84 and applied for the subsequent years also. Thus, the absolute differences have been taken to find the correlation with different financial indicators.

We feel that going forward the strength of rupee will be driven by the economic condition in the euro zone vis-à-vis the domestic policies reforms undertaken in India. As mentioned above, the rupee will remain volatile on uneven flows in the stock markets which are sensitive to various domestic and international economic and political developments.

While, intensifying of euro zone crisis would tend to drive the rupee downwards, domestic policies with special reference to improving investment environment in India can help the rupee strengthen against the dollar in the days to come.

3. Weak Rupee may not buy trade

It has been observed that weak rupee may not buy trade in terms of exports growth and improving trade balances. The weak rupee performance vis-à-vis export behavior varies during the good and the bad years. It was found that India's exports grew robust in the rupee appreciation years and decelerated during the rupee depreciation years.

Within the span of the last 10 years, the rupee appreciated significantly during 2007 against the dollar whereas, the India posted healthy export growth of about 15%. The high export growth despite dear rupee may be attributed to normal world economic conditions and strong world demand which is evident from world GDP growth of 5.4% supported by domestic conditions (India's GDP grew at 10%).

Exports and Imports growth vis-à-vis demand in world and India

	Re/US\$ (Annual Avg)	GDP growth (%)		Exports growth (%)		Imports growth (%)	
		World	India*	World	India	World	India
2001	47.18	2.3	3.88	-0.53	5.86	-0.78	-0.05
2002	48.59	2.8	4.55	3.74	14.12	4.14	8.02
2003	46.58	3.6	6.85	7.07	12.37	7.72	9.37
2004	45.31	4.8	7.59	11.23	12.91	12.12	22.83
2005	44.10	4.5	9.03	7.75	10.81	8.06	15.36
2006	45.33	5.3	9.53	9.36	6.51	8.85	4.94
2007	41.29	5.4	9.99	7.41	14.78	7.54	16.59
2008	43.42	2.7	6.18	2.87	6.47	2.77	14.04
2009	48.35	-0.6	6.77	-11.72	5.45	-12.29	7.63
2010	45.73	5.1	10.09	14.04	19.85	14.07	10.66
2011	47.06	3.9	7.83	8.07	15.36	8.77	11.23

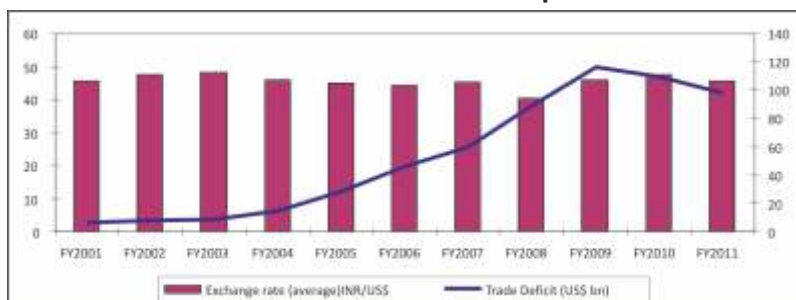
Source: PHD Research Bureau, compiled from IMF

* Indian's GDP growth is based on factor costs and current market prices

On the other hand, during the Post-Lehman global financial crisis period, the rupee depreciated significantly against the dollar in 2009, when India's exports growth stagnated at about 6%. It may be mentioned that the world demand decelerated considerably with GDP growth at -6% and India's GDP at 6.7% in 2009.

The trade deficit of India has been increasing over the last decade from around US\$ 6bn in FY2001 to around US\$98bn in FY2011. In case of this also, a similar trend was observed wherein, the widening of trade deficits was found to be dependant on overall global demand and not exchange rate of rupee. It is clear from the fact that when the rupee appreciated during FY2007, the trade deficit was at a moderate level of around US\$59bn. However, when the rupee met with significant depreciation during the Lehman crisis year FY2009, the trade deficit also touched its decadal peak of around US\$116bn. Thus, weak rupee may or may not help to improve the trade balance. It is largely dependant on the global economic conditions and overall demand situation.

Trade deficit vis-à-vis rupee



Source: PHD Research Bureau, compiled from RBI

4. Industry performance

Industry performance in terms of aggregated level for five export oriented industries¹ have been studied and it revealed that rupee appreciation/ depreciation does not have any significant impact on industry exports performance in terms of growth and export sale ratio. The exports growth of these select industries declined to about 8% in FY2008 with significant rupee appreciation from the average of about 18% exports growth in FY2006 and FY2007. However, even during the year of depreciation FY2010, the exports growth exhibited deceleration at about 8% from the average growth of about 17% during FY2008 and FY2009. Hence the export growth of industries has declined significantly from the average growth during appreciation and depreciation phases. A similar trend was witnessed in case of imports growth of industries, which significantly from declined from average growth during appreciation and depreciation era.

Trend in Exports and Imports vis-à-vis Exchange rate

	FY2006	FY2007	FY2008	FY2009	FY2010
Exchange rate INR/US\$ (Average)	44.2	45.2	40.2	45.9	47.4
India's Export growth (%)	21.6	25.28	14.71	28.19	0.57
India's import growth (%)	31.8	27.27	20.44	35.77	-0.78
Export sales ratio [^]	32.93	33.21	32.10	36.49	36.47
Export growth (%) [^]	17.41	18.06	7.78	26.81	8.28
Import sales ratio [^]	9.42	10.80	11.97	13.24	11.47
Import (growth) [^]	54.44	34.13	23.66	23.40	-6.15

Source: PHD Research Bureau, compiled from various sources

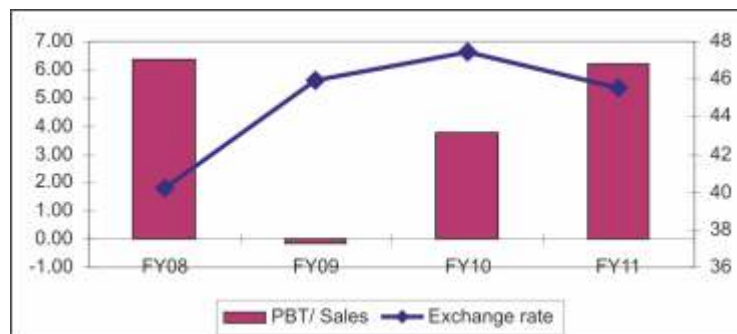
Note: [^] The data pertains to five industries namely Drugs & Pharmaceuticals, Leather apparel & clothing accessories, Machine tools, Marine products and Tea.

A closer look at these industries revealed that when rupee appreciated, the export-sales ratio of industries stood at 32.10%, which remained close to the average export-sales ratio of 33.07% during FY2006 and FY2007. On the other hand also, during rupee depreciation, the exports-sale ratio of industry stood at 36.47% and remained close to the average export sale ratio of 34% during the last two years. Hence, the rupee depreciation/ appreciation does not have significant impact on the export sales and import sales ratios.

Further, to understand the impact of rupee appreciation/ depreciation on profitability, the profits to sales ratio of companies were studied. The aggregate profit before tax for seven export oriented sectors were deflated by their aggregate annual sales to arrive at the ratios. It was observed that during FY2009, when rupee met with significant depreciation from Rs40/ US\$ in FY2008 to Rs46/US\$ in FY2009, the profit to sales ratios dipped considerably from 6.36% to -0.17%. However, in the year of rupee appreciation in FY2011 when rupee appreciated from Rs47.4/US\$ to Rs45.5/US\$ the profit-sales ratios improved significantly from 3.7% in FY2010 to 6% in Fy2011.

¹ Note: The data pertains to only five industries namely Drugs & Pharmaceuticals, Leather apparel & clothing accessories, Machine tools, Marine products and Tea.

PBT/ Sales ratio vis-à-vis rupee



Source: PHD Research Bureau, compiled from various sources

Thus this shows that weak rupee may not improve the profitability of corporates in India. The cause for this could be attributed to the high import content of Indian exports which makes imports dearer in years of weak rupee, shrinking the price-cost margins.

5. Conclusions

The currencies of many emerging and developing economies suffered large depreciations with the onset of the global financial crisis during 2011 and have shown significant volatility, coinciding with the world economic and financial conditions. Collapsing trade and financial flows led to substantial balance of payments gaps, triggering fast depreciations and higher exchange rate volatility in recent times. Rupee along with most of the BRICS economies has depreciated significantly against the dollar in the recent months.

During the post reforms phase, since 1990s, the trade trajectory and trading volumes of Rupee has enlarged manifold with rise in India's global integratedness. The share of the Rupee in total global currency turnover has increased over the last decade as India's global openness has risen, year after year.

Empirical evidences have shown that a weak rupee scenario will only benefit the trade performances and profitability in the rational macro environment in the world economic system. A downturn in rupee may not be conducive for trade if the demand situation in the destination countries is not favourable and leaves less scope for exports to grow more even if India's export turns competitive due to depreciating rupee. Similarly, in case of profits, a weak rupee, although may increase export earnings, but may push up input costs by making imports dearer and lead to an unfavourable price cost margin in case of export oriented corporates.

Hence, going ahead, the rupee is slated to remain volatile in the coming times in the wake of global economic developments which is driving uneven fluctuations in the capital flows. So at this juncture, we feel that the strength of rupee will be driven by the economic condition in the euro zone vis-à-vis the domestic policy reforms undertaken in India.

The economy so far April 2012

Components	Growth/Rate
Gross Domestic Product* (FY2012)	
GDP at current market prices	Rs 8,912,179 cr
GDP at factor cost at constant prices	Rs 5,222,027 cr
GDP growth (YoY % change)*(FY2012)	
Nominal GDP-factor cost	15.7%
Real GDP-factor cost (constant prices)	6.9%
Agriculture, forestry & fishing	2.5%
Industry	3.5%
Manufacturing [^]	3.7%
Mining [^]	-2.1%
Electricity [^]	8.7%
Basic Goods [^]	5.9%
Intermediate Goods [^]	-0.9%
Capital Goods [^]	-1.8%
Consumer Goods [^]	4.8%
Consumer Durables [^]	2.7%
Consumer Non-Durables [^]	6.5%
Construction	4.8%
Services	9.3%
Trade, hotels, transport & comm.	11.2%
Financing, Ins., Real Est. & Bus. Services	9.1%
Community, social & personal Services	5.9%
Infrastructure**(YoY % Δ) April- FebFY12	
Core Infrastructure Industries	4.4%
Crude Oil	1.4%
Refinery products	3.4%
Coal	0.4%
Electricity	8.6%
Cement	6.4%
Finished Steel	6.8%
Fertilizer	0.3%
Natural Gas	-8.8%
Demand side factors as % real GDP(Market prices) * (FY2012)	
Private final cons. expenditure	58.1%
Δ Private final cons. expenditure	6.45%
Government final cons. expenditure	11.0%
Δ Government final cons. expenditure	3.91%
Gross fixed capital formation	31.9%
Δ Gross fixed capital formation	5.63%
Monetary policy as on April, 2012***	
Bank Rate	9.50%
SLR	24.00%
CRR	4.75%
Repo Rate	8.50%
Reverse Repo Rate	7.50%
Money Supply M3 YoY as on Mar23, 2012****	13.0%
Credit Growth YoY as on Feb, 2012****	15.7%

Money market as on 13April, 2012***	
Base Rate	10.0%-10.75%
Saving Bank Rate	-
Deposit Rate	8.50% -9.25%
91 Day T-Bills (cut off at last auction)	8.77%
182 Day T-Bills (cut off at last auction)	8.55%
364 Day T-Bills (cut off at last auction)	8.34%
Call Money Rates as on March 11,2012	7.25% -8.95%
Balance of Payments***	
Trade Balance Q2 FY2012	US \$ (-)43.9 bn
Current Account Balance Q2 FY2012	US \$ (-)16.9 bn
Capital and Finance Account (Net Balance) Q2 FY2012	US \$ 18.4 bn
Overall Balance of Payments (Apr-SepFY2012)	US\$5.7 bn
Capital Flows***	
FDI equity to India Apr-Dec FY2012^^	US\$ 24.1 bn
FII (net) Apr-Dec FY2012^^	US\$ 2.74bn
External debt end- Sep(2011)	US \$326.6 bn
ECB's Apr-Jan FY2012	US\$ 29.5 bn
Foreign Exchange Reserves as on end March,2012	US\$ 294.39 bn
Fiscal Indicators	
Gross Fiscal Deficit (Centre - as a % of GDP) FY 11	4.7%
Revenue Deficit (Centre - as a % of GDP) FY 11	3.1%
Inflation** (YoY % growth)- Feb2012	
WPI of all commodities	6.89%
Primary articles	9.62%
Food Articles	9.94%
Non Food	-1.20%
Fuel and power	10.41%
Manufacturing Inflation	4.87%
Consumer Price Inflation(Jan2012)	7.65%
Foreign Trade@ April -Feb FY12	
Exports	US \$ 267.4bn
Exports growth	21.4%
Imports	US \$ 434.2 bn
Import Growth	29.4%
Trade Balance	-US\$166.8 bn

Source: PHD Research Bureau, compiled from various sources.

Note: *CSO Advance Estimates of National Income 2011-12;

[^] CSO's Quick estimates of IIP for Apr- Feb FY2012;

** Office of the Economic Advisor, Govt. of India;

*** RBI;

@ Ministry of Commerce & Industry, Govt. of India, ^^DIPP.

About the PHD Chamber

PHD Chamber is a vibrant and proactive representative organization of business and mercantile community of northern and central India, serving their interest for over a century. This apex regional organization plays a active role in India's development and acts as a much needed link between government and industry, serving as a catalyst for rapid economic development and prosperity of the community in the region through promotion of trade, industry and services.

With its base in the National Capital, Delhi, the Chamber has Regional offices in States of Bihar, Chhattisgarh, Haryana, Himachal Pradesh, Jammu & Kashmir, Madhya Pradesh, Punjab, Rajasthan, Uttar Pradesh, Uttarakhand and the Union Territory of Chandigarh.



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Notes