



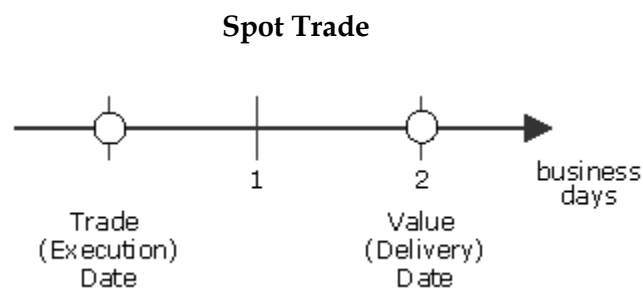
Understanding FX Spot Transactions

A Guide for Microfinance
Practitioners

Foreign Exchange Spot

Use: The Spot Contract is the most basic foreign exchange product. Microfinance clients use this product to buy and sell a foreign currency at the current market exchange rate. This product is used for immediate exchange of funds.

Structure: A spot contract is a binding obligation to buy or sell a certain amount of foreign currency at a price which is the "spot exchange rate" or the current exchange rate for settlement in two business days time. The trade date is the day on which a spot contract is executed. The settlement date is the day on which funds are physically exchanged as per market convention for "spot delivery" (this is the day when the funds will show in the receiver's account).



The difference between the trade date and the settlement date in a spot transaction reflects both the need to arrange the transfer of funds and, the time difference between currency centers involved.

Pricing: Pricing of foreign exchange or the spot exchange rate is determined by the demand and supply of the currency in the market.

The demand and supply of a currency can be affected by a country's current rate of inflation and expected future inflation rates, the country's balance of payments, the monetary and fiscal policies of the country's government, various economic indicators which create expectations about the country's economic health, differences between foreign and domestic interest rates and central bank interventions.

A foreign exchange rate quotation consists of two currencies: the 'base' (fixed) currency and the 'term' (variable) currency. A quotation shows how many units of the terms currency will equal 1 unit of the base currency. Banks quote the base currency mostly in terms of the Euro, the Pound Sterling or the U.S. Dollar.

See below the quoting convention for the U.S. Dollar versus the Ethiopian Birr (ETB).

$$\text{ExchangeRate} = \text{BaseCurrency} - \text{TermCurrency} \Leftrightarrow \frac{\text{VariableCurrency}}{\text{FixedCurrency}}$$
$$\text{USD} - \text{ETB} : 9.8600 \Leftrightarrow \frac{\text{ETB}}{\text{USD}} = \frac{9.8600}{1} \Leftrightarrow \frac{\text{ETB}}{\text{USD}} = \frac{1}{9.8600} = 0.1014$$

According to the exchange rate quoted above, it takes ETB 9.8600 to buy USD 1.00 and USD 0.1014 ($1 \div 9.8600$) to buy ETB 1.00.

Constraint: Spot exchange rate movements are highly unpredictable, even during a single trading day. Relying on the spot market for future foreign exchange can be risky as it exposes cash flows to the risk of unfavorable changes in foreign currency values.

Spot Contract Pros	Spot Contract Cons
Simplest foreign exchange rate product for immediate execution	Cash flows are vulnerable to prevailing exchange rates at trade execution