A fixed exchange rate regime

Finance

In Figure 2, as the aggregate demand curve shifts from D0 to D1, the aggregate supply curve also shifts from S0 to S1 since the exchange rate is fixed. The increase in the aggregate supply of domestic currency is usually done through the central bank intervention in the foreign exchange market.

2. The higher a country's interest rates, the greater the demand for that currency. (" Exchange Rate", 2006) When foreign interest increases, foreign investments are more attractive. As domestic people want to exchange domestic currency to foreign currency in order to earn more interest, the demand for domestic currency would decrease. Under the floating exchange rate regime, as shown in Figure 3, as the demand for a domestic currency decreases, the aggregate demand curve shifts from D0 to D1, causing the exchange rate to rise from e0 to e1. Under the fixed exchange rate regime, however, as the demand for a domestic currency decreases from D0 to D1 as a result of the increase in foreign interest, the aggregate supply of domestic currency must also decrease, from S0 to S1, as shown in Figure 4.