[Central Bank Intervention]

Unsterilized Intervention: The government can buy or sell foreign exchange to affect the value of the nominal exchange rate with no corresponding countervailing operation in the open bond market. Selling dollars and buying DM would increase the Federal Reserve Bank's reserves and hence would increase the domestic US money supply. So the Fed is buying DM balances instead of long dated bonds.

Sterilized Interventions: The bank sells long dated bonds to absorb the dollars created by the intervention. This keeps the money supply at the previous level through increasing the holdings of bonds and reducing the holdings of foreign exchange.

In practice the central banks tend to sterilize by keeping the short term interest rates unchanged; i.e. when selling dollars the Fed buys supplies or removes just enough funds to keep maintain interest rates constant. Central banks generally sell foreign currency through the Eurobond market, where dollar denominated bonds can be exchanged for bonds denominated in different currencies. Also, the US Federal Reserve acts as a banker for the other central banks in terms of keeping gold for each bank and moving the appropriate amount of gold from one banks deposit to another.

In recent times the policy aim has been to support the $ against the strong DM. The Federal reserve bank can buy $ and sell DM, which reduces the US money supply. To keep the money supply constant, the Fed will have to buy bonds from the banking system. To facilitate this procedure, the Fed has accounts with the individual commercial banks.

Sterilized intervention is only useful in the short term; it can not be useful to change the long run value of a currency. When intervention is unsuccessful, the only alternative is to change monetary policy, e.g. the UK in May, 1988.

A major question is how successful is intervention? Can a bank or government really support an over valued currency? Experience in the summer of 1992 suggests that intervention is really not a good policy instrument.