Dollar Reserves and U.S. Yields Identifying the Price Impact of Official Flows

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This paper shows that the price impact of foreign official (FO) purchases or sales of U.S. Treasuries (USTs) is about twice as large as previously reported in the literature once critical sources of endogeneity are addressed. We also show that prevailing estimates of this price impact suffer from omitted variable bias when foreign government bond yields and Federal Reserve policies are not controlled for. By exploiting changes in the volatility of FO flows and U.S. yields after the 2008 Global Financial Crisis, we identify a FO flow shock via heteroskedasticity in a structural VAR. We estimate that a $100B flow shock moves the 5-year, 10-year, and 30-year yields by more than 100 basis points on impact, compared to the 19-44 basis points range that we estimate by assuming FO flows are price inelastic and without controlling for foreign yields and Fed actions. Our findings suggest that FO sales of USTs played a critical role during the March 2020 episode of Treasury market turmoil and that even a small reduction in the Dollar's share of China's reserves could have a significant impact on U.S. long-term interest rates.