

# The world has changed



China and Russia aim to weaken the US hegemony and the reign of the greenback. The tragic invasion of Ukraine could be seen as one step in a long-term process.

In our latest Focus, we reflect on the profound changes at play, and the pressures the long-standing US supremacy is under. Its dollar is being questioned as an absolute reference for global trade, and flexing its military muscles seems to be less intimidating than it once was. In a world vastly different than the petrodollar world economy Richard Nixon helped shape, Chinese President Xi will play a key role in the new global balance of power.

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Almost exactly 50 years ago, US President Nixon returned from a week-long diplomatic visit to China. The success was unequivocal: he had convinced his Chinese counterpart to move away from the Soviet orbit and help America spy on the USSR. Nixon was then re-elected. The stage was set for China's eventual integration into the world economy.

Today, the world has changed. China's role in the international system has taken on far greater proportions than Nixon had imagined. On the Chinese side, President Xi Jinping makes no secret of his view that America is a declining superpower that will do anything to block China's inexorable rise to global supremacy. Donald Trump had begun a decisive turnaround by imposing tariffs on Chinese products. Now President Biden, who has rallied Europe, Australia and Japan in his fight against autocracy and the promotion of democracy around the world, presents a more complex problem for Xi Jinping.

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However, by talking about a fight between the "free world" and dictatorships, the Biden administration runs the risk of bringing Russia and China together in what some call a "new axis of autocracy".

This rapprochement could prove to be one of the most important geopolitical developments in decades, in some ways the antithesis of what Nixon tried to achieve in the 1970s.

Russia and China are not natural allies and Chinese leaders have long argued for a world without formal military alliances, avoiding entanglement in other countries' military conflicts. However, Putin and Xi have many common interests. Both men were deeply shaken by the collapse of the Soviet Union. Both have cracked down hard on dissent or circumvented presidential term limits, which should allow them to remain in power indefinitely. But above all, they share the same vision - that of the end of American hegemony - while aspiring to restore their respective countries' role as super powers, with the ultimate goal of recovering territories they consider to have been lost: Ukraine, in the case of Russia, and Taiwan, in the case of China.

A few hours before the opening night of the Winter Olympics in Beijing, a major event went almost unnoticed. Putin and Xi Ping issued an extraordinary joint declaration, promising that their cooperation would be "superior" to that forged between the two countries during the Cold War. This includes armaments and defense policy. China now supports Russia's demand to stop NATO enlargement. Russia supports China's claim to Taiwan.

But their joint statement is also a manifesto calling on the US to recognise that it is no longer the world's policeman. The world has changed, they say. Russia and China must be respected as 'global powers' that can dictate what happens in their own backyard.

This confrontation with the Western world - and primarily the United States - is not just geopolitical. Indeed, the two allies of circumstance have engaged in an economic war with the US, through control of the global supply chain and energy prices. By accumulating gold and dumping US Treasuries, they are trying to strip the dollar of its status as a reserve currency.

As a reminder, the Bretton Woods monetary system was organised around the US dollar, linked to oil. More than a multilateral monetary system, Bretton Woods was a military, political, economic and energy domination of the United States. The end of the Bretton Woods system in the early 1970s did not change the situation. It even allowed the advent of the dollar standard, with the greenback replacing gold as a guarantee of stability and therefore as the world's primary reserve currency.

The fact that the dollar had this status meant that the United States did not have to build up foreign exchange reserves in the currencies of other countries, and above all that it could finance its balance of payments deficits thanks to its power of monetary creation. Indeed, the additional issuance of dollars makes it possible to finance the US debt at a lower cost, as US Treasury bonds are favored by other states to build up their reserves.

However, the US government abused its privilege, accumulating massive debts, creating rampant inflation as it exited the Covid-19 crisis and paying back its creditors in devalued dollars. At the same time, the dollar now faces a double challenge: first, the rise of the Chinese renminbi (RMB). But also the retreat of the United States on the global military stage.

Indeed, the US military is retreating, a trend that started under Trump and continuing under Biden with the withdrawal of troops from Afghanistan. Once the world's policeman, Biden's America has turned into a mere observer of the Russian invasion of Ukraine. This is a boon that Putin has obviously taken advantage of.

With a muted US military, is there still a need for the petrodollar reserve currency system? Moreover, given the continued depreciation of the real value of the greenback, why should trading partners continue to settle their transactions in dollars?

The Sino-Russian couple has perfectly seized this opportunity and has the capacity to exacerbate American weakness. Firstly, by contributing to inflationary pressures. In recent months, Joe Biden's popularity has plummeted, particularly as purchasing power has fallen due to a 40-year high in inflation. Although this inflation is fueled by ultra-expansionary fiscal and monetary policies, the behaviour of Russia and China plays an important role. Russia is one of the world's largest energy exporters and the escalation of the Ukrainian crisis in recent months has contributed to further tightening the energy market, putting additional pressure on inflation. On the other hand, China, as the world's factory, has played a key role in the slowdown of global supply chains during the Covid-19 crisis. China also has a propensity to hoard essential goods (notably agricultural commodities) through export restrictions, contributing to higher commodity prices. Russia and China are adding to inflationary pressures, a dynamic that weakens the Biden administration's ability to govern at home. When domestic conditions become more difficult, leaders

generally have less leeway to act on foreign and military policy.

Another dynamic that is unfavourable to the United States is the fact that global commodity transactions are less and less denominated in US dollars. This is largely driven by China, which is steadily moving towards settling its commodity transactions - particularly oil - in RMB or gold. This trend has been in place for several years and the Sino-Russian alliance only reinforces it. This has a major consequence for the US: as the dollar is used less and less in trade, it becomes less necessary for foreign countries to hold treasury bills in reserve. In the long run, this new paradigm could

increase the borrowing costs for the US government and de facto reduce Uncle Sam's ability to finance his armament programmes. A context that would leave the field open to Russian and Chinese dreams of territorial (re)conquest.

The Russians and Chinese are even in a position to accelerate the rise in US debt yields and to reinforce the attractiveness of gold by using their very large foreign currency reserves. For example, the yellow line, which represents the amounts held in US Treasuries, has literally collapsed over the last two years. The Blue line - the amounts of gold - has conversely exploded upwards.

Russia Gold and US Treasury holdings in \$ billion



Source: Bloomberg

According to UBS, the dollar share of Russia's foreign currency reserves, which currently stands at \$640 billion, has fallen to 16% in 2021, from 46% in 2017. In comparison, the share of the yuan has increased to 13%, from less than 3%. Sanctions are expected to further reinforce this trend. Indeed, the Chinese equivalent of SWIFT - the Cross-Border Inter-Bank Payments System (CIPS) - appears to be an alternative payment method between Russians and Chinese. Another development linked to the conflict in Ukraine is that India, which has a very important need for fertilisers from Russia, is considering bypassing the sanctions by paying for its purchases in Indian rupees rather than US dollars.

The meeting of Mr Xi and Mr Putin prior to the Winter Games could therefore mark a turning point. Both leaders seem to have decided that the time has come to accelerate their 'de-dollarisation' strategy. They see a weakened United States suffering from massive inflation and withdrawing militarily abroad. This gives them a window of opportunity to carry out large-scale military operations.

Is the world really changing? Yes, but with a number of caveats. First, let's not forget that it is Russia that is currently facing an unprecedented banking crisis and a collapse of its ruble - not the West. Let us also remember that Russia remains an economic "dwarf", with the West

remaining by far the most important economic power. It is true that the economic weight of the United States and Europe is declining on a relative basis, but this is a consequence of the growth of emerging countries and not a decline of Europe and the United States in economic and geopolitical terms as such. As far as defense policy is concerned, it would seem that the war in Ukraine has had the effect of stimulating the West, since countries such as Germany have just announced their intention to increase their arms spending budget. Finally, the solidity of the relationship between China and Russia is relative and will certainly undergo a very important test in the coming weeks. Indeed, the West remains the main commercial outlet for the Chinese. It is therefore unlikely that China will sacrifice the immense opportunities it has for the sake of its increasingly isolated Russian partner.

As Lenin said: "There are decades when nothing happens; and there are weeks when decades happen". Between the Fed's monetary tightening cycle, the war in Ukraine and new tensions between China and Taiwan, the world is indeed on the move.

## Sources

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Not Ukraine but rather US is losing – Ibrahim Karatas

Russia isn't attacking Ukraine. They (and China) are attacking the US\$ - Craig Shapiro

The Market Ear

## For further information

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