VIEWS 87/25 | 29 DECEMBER 2025

The End of the American Deficit: Navigating the New Era of American Protectionism (Part 1)

Azfar Hanif Azizi

The Crisis of the Export-Led Model

Introduction

As 2025 draws to a close, it is clear that the year will be defined by a single, seismic rupture in the global economic order. Eight months have passed since President Trump announced his "Liberation Day" tariffs on April 2, 2025, a watershed moment that spared no trade partner from a unilateral hike in import duties. While the initial shock has subsided, the structural reality of the new American trade policy has arguably become the most significant determinant of Malaysia's future development strategy. Under this regime, countries recording a merchandise trade surplus with the US were penalised with duties derived from their trade surplus ratio, discounted by half, while even deficit countries faced a baseline 10% levy.

For Malaysia, the mathematics were significant, though not as severe as for some regional peers. With a USD 24.9 billion positive trade balance against USD 52.5 billion in exports to

Views are short opinion pieces by the author(s) to encourage the exchange of ideas on current issues. They may not necessarily represent the official views of KRI. All errors remain the authors' own.

This view was prepared by Azfar Hanif Azizi, a researcher from the Khazanah Research Institute (KRI).

Author's email address:
azfar.azizi@krinstitute.org

Information on Khazanah Research Institute publications and digital products can be found at www.KRInstitute.org.

the US in 2024, Malaysia was initially slapped with a 24% tariff, which briefly rose to 25% in July. In the intervening months, Putrajaya has scrambled to mitigate the damage, culminating in the recently signed Agreement on Reciprocal Trade (ART). Under this new pact, Malaysia secured a reduction of the tariff wall to 19% and achieved zero-rating for 1,711 specific tariff lines. Furthermore, the deal solidified the purchase of Boeing aircraft in a framework valued at USD 19 billion, a procurement expeditiously finalised to grease the diplomatic wheels.

It is not my intention here to assess whether this 5% reduction was worth the concessions. However, the deal serves a specific defensive purpose: it "locks in" the 19% rate against the constant threat of a "snapback" to the original 24-25%. Yet, focusing on the specific rate misses the forest for the trees. By declaring the US trade deficit a "national emergency" on Liberation Day, the US has signaled a resolve to transform from the world's "consumer of last resort" into a nation determined to achieve balanced trade or a potential surplus.

Whether the US can successfully defy macroeconomic gravity to achieve such a radical rebalancing remains uncertain. However, the success of the outcome is secondary to the disruption of the attempt. The aggressive policy shift itself, manifested in punitive tariffs and coercive agreements like the ART, is already dismantling the foundations of the US-dependent export model. Moreover, this protectionist turn is likely structural rather than transient. History suggests that such measures, once implemented, tend to endure regardless of the party in power, much like the Biden administration retained and expanded the tariffs from Trump's first term. We need not wait for a US trade balance or surplus to materialise to witness the damage; the mere pursuit of this goal is already exacting a heavy toll on Malaysia's economy and sovereignty.

The Zero-Sum Game of Global Trade

Why does a US pivot toward balanced trade or a potential surplus cause such acute problems for Malaysia and the developing world? The answer lies in the accounting identity of global trade: one country's surplus is, by logical necessity, another's deficit.

In a simplified two-country model, if Country A exports more than it imports, Country B must import more than it exports. In our complex multilateral world, the US has historically played the role of Country B, running massive deficits that allow the rest of the world (ROW) to run surpluses. These surpluses allow developing nations to accumulate savings and foreign reserves.

If the US succeeds in its goal to achieve balanced trade or a potential surplus, the global equation must rebalance. The rest of the world must collectively reduce their surpluses. This shift presents four critical hurdles for Malaysia:

1. **The Balance of Payments Constraint:** A US move toward balanced trade or a potential surplus acts as a drag on global growth, enforcing a hard limit on developing nations' capacity to import essential capital goods.

2. **The "Exorbitant Privilege" Gap:** No other economy can replace the US as the global consumer. The Eurozone is constrained by fiscal pacts (Maastricht Treaty) that suppress aggregate demand, while China strategically prioritises industrial production over consumption. Meanwhile, other nations simply lack the monetary privilege to sustain prolonged deficits without currency collapse.

3. **Structural Rigidity:** Switching export destinations is not merely a matter of logistics; it is a structural impossibility in the short run. This is compounded by the fact that many Malaysian manufacturers are US MNC subsidiaries producing intermediate goods specifically for their parent companies' final products, effectively locking them into rigid, intra-firm supply chains.

4. **Financial Fragility:** If the US achieves balanced trade or a potential surplus, developing nations are forced out of surplus, effectively stripping them of the ability to accumulate US Treasuries, the vital "safe assets" needed to buffer their financial systems against external shocks.

The Economic Mechanics: Thirlwall's Law and the Balanced Trade Multiplier

To understand why the loss of the US deficit is catastrophic, we must look beyond the simple GDP identity ($Y = C + I + G + (X - M)$) and consider the Balance of Payments Constrained Growth Model, often referred to as Thirlwall's Law.

Critics might argue that a decline in Net Exports ($X - M$) can be easily offset by boosting Domestic Consumption (C), leaving overall Output (Y) unchanged. This perspective rests on precarious assumptions: primarily, that labour and capital possess perfect mobility, allowing a semiconductor engineer to instantly pivot to the domestic service sector, a transition that, even if successful, typically results in the underemployment of specialised skills and a significant drop in value-added output; and second, that exchange rate depreciation will automatically rebalance trade by making exports cheaper.

However, this view fundamentally misinterprets the structural reality of a developing economy by treating all demand as currency-neutral. In reality, domestic and external demand differ crucially in the currency they generate. Domestic consumption is paid for in Ringgit, whereas external demand (exports) earns foreign exchange (forex), typically US Dollars. This distinction is vital because a developing nation like Malaysia relies on imports, advanced machinery, high-tech components, and energy like coal, to fuel its growth. These essential inputs must be purchased with forex, not Ringgit.

This is not to say that trade is useless without a surplus. Even in a scenario of balanced trade, where exports equal imports ($X=M$), expanding the gross volume of exports remains critical. We can see this through the derivation of Harrod's Foreign Trade Multiplier. If we accept that imports are determined by national income ($M = mY$, where m is the propensity to import), and we enforce the condition of balanced trade ($X = M$), we arrive at the identity $X = mY$. Solving for income gives us $Y = (1/m) X$. This demonstrates that the size of an economy (Y) is essentially a multiple of its export volume (X).

Simply put, exports provide the "foreign exchange room" for the economy to grow. High export volumes allow a developing nation to finance high import volumes of capital goods and technology that cannot be produced domestically. This technology transfer increases the productive capacity of the entire economy, creating a super-multiplier effect on growth that domestic consumption alone cannot replicate. Therefore, the goal is not necessarily a perpetual surplus, but the ability to maintain high export volumes to finance development. The US contraction threatens this by shrinking the total volume of trade available.

Therefore, if exports to the US collapse, Malaysia loses the hard currency revenue needed to pay for these growth-enabling imports. We effectively hit a "balance of payments wall." Attempting to replace this lost external demand by simply printing Ringgit to stimulate domestic consumption fails because the resulting spending leaks into higher imports without the corresponding forex earnings to pay for them. This imbalance widens the trade deficit, triggers a sell-off of Ringgit assets, and forces currency depreciation, which ultimately imports inflation. Thus, export earnings are not merely a component of GDP to be swapped out; they are the financing mechanism for the imports required for sustainable domestic growth. Without the US deficit fueling our exports, our domestic ceiling is lowered.

The Political Cost: Sovereignty as Collateral

The "structural rigidity" of the current US-dependent export model is not merely economic; the ART has revealed it to be political as well. To maintain access to the US market, Malaysia must accept clauses that introduce significant external constraints on its independent decision-making capacity.

First, the ART includes a "Third Nation" clause in several places. In Article 5.1, for example, the US expects Malaysia to impose import restrictions equivalent to those imposed by the US on a third country that the US deems a threat to its economic or national security. It is, however, somewhat uncertain how strictly Malaysia must comply with a US request, as the wording states that Malaysia “shall adopt … a measure with equivalent restrictive effect… to address a shared economic or national security concern…”. It could be argued that Malaysia does not share an economic or national security concern with the US on a third country that the US finds concerning, and therefore does not need to impose equivalent import restrictions. However, the US retains the leverage to render this distinction moot; by threatening tariff escalation, Washington can effectively force Malaysia to adopt US security concerns as its own economic imperatives. Article 5.3 Paragraph 3, on the other hand, allows for the reimposition of tariffs if Malaysia enters into trade agreements with economies deemed detrimental to US interests. This clause functions as a strategic tether, effectively granting the US decisive influence over Malaysia's trade diplomacy. It creates a punitive "snapback" mechanism that constrains Malaysia from freely pivoting to alternative markets, placing a prohibitive economic cost on any sovereign diversification strategy that lacks American approval.

Second, the agreement restricts Malaysia’s capability to utilise its state-owned enterprises for industrial and developmental objectives. Article 6.2 mandates that State-Owned Enterprises (SOEs) must act solely on "commercial considerations." Although exemptions for "public services" exist, this clause places rigid boundaries on the state's economic toolkit. By limiting the use of State-Owned Enterprises as vehicles for non-commercial industrial upgrading, the ART significantly curtails the government's ability to direct strategic sectors, nurture infant industries, or prioritise local vendor development. Under this regime, state interventions designed to foster domestic capabilities are constrained by the rigid demands of international trade compliance. Readers seeking a more comprehensive analysis of these constraints and their implications for Malaysia's developmental state should refer to the recent three-part Views written by Yin Shao Loong.

Conclusion

International trade offers developing nations a pathway to accelerated growth and technological advancement. However, recent geopolitical trends reveal a potentially prohibitive cost, particularly when dominant trade partners leverage economic ties to erode national autonomy and enforce alignment with their interests. The ART is more than a mere trade agreement; it manifests a new geopolitical reality where market access is tethered to heavy political constraints. While Malaysia's strategic commitments secure immediate commercial certainty, they arguably limit the scope for autonomous long-term development. Yet, these constraints on sovereignty and industrial policy are merely the visible symptoms of a deeper malaise. Beneath the surface of trade negotiations lies a fundamental rupture in the global financial order—one that threatens the liquidity powering developing economies. Part 2 will examine these structural fragilities, from the 'Consumer of Last Resort' dilemma to the global liquidity squeeze, and outline the radical strategic shifts Malaysia requires to navigate this post-deficit world.