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Behind Japan's U.S. Steel Bid:

An Aging, Shrinking Home Market

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INTRODUCTION

When Japan's industrial titan Nippon Steel sought to acquire U.S. Steel late last year, it set off a chorus of American opposition.

Union leaders and lawmakers railed against the deal in language reminiscent of the U.S.-Japan trade wars of the 1980s and 1990s. President Biden — nodding to swing state votes in steel country — said U.S. Steel must remain "domestically owned and operated."

Leave aside the election year politics — and how it tests the ability of an American company to pursue what it sees as the most logical strategy for itself. The bid reflects Japan's rise to the largest foreign investor in American businesses. And this investment surge is unlike those of years past when Tokyo's overseas expansion was part of its rising economic clout. Today, the opposite is true.

Japan's relentless population decline is causing its market to shrink. So Japanese companies are turning to the U.S. for growth, thereby setting a precedent for other foreign companies facing similar demographic challenges in their home markets.

It is a precedent Washington policymakers would do well to note. The Nippon Steel bid illustrates how, in the coming years, more foreign companies with declining populations are going to seek to invest in the U.S.

This is a trend the U.S. should welcome and seek to leverage while making sure investments come from trusted allies, not from strategic rivals, including China, to avoid leakage of technology.

Foreign investments — particularly those in manufacturing — create both jobs and fresh opportunities for local businesses. Rural areas such as midwestern factory towns will be beneficiaries.

Allied investments bring capital and innovation that allow the U.S. to better compete against China. The Biden administration, through "friend-shoring," is already working with allies and like-minded nations to strengthen and secure supply chains for critical products. That strategy should include embracing U.S.-bound investments from those same close allies, starting with Japan.

Big beneficiaries of this approach will be American workers, especially those without college degrees, who tend to gain from good manufacturing jobs.

DEMOGRAPHICS AND NATIONAL SECURITY

Major economies in Europe and Asia are facing the same demographic challenges that have long haunted Japan. Plummeting fertility rates and growing cohorts of elderly citizens sharply reduce consumer demand. The result is a huge incentive to seek growth in the U.S., the world's largest market where immigration has softened the burdens of the global aging phenomenon.

For many foreign companies, the U.S. remains the most attractive investment destination. The Inflation Reduction Act and the CHIPS and Science Act have offered businesses tax benefits and subsidies, luring tens of billions of dollars in new investments from Asia and Europe. A right mix of policies would attract even more foreign money, spurring job creation, innovation, and more prosperity.

In Japan, meanwhile, domestic steel demand is down by some 40% from its 1990 peak. So the leading Japanese steelmaker has sharply expanded its overseas capacity, snapping up factories in countries from India to Brazil.

The proposed U.S. Steel deal would make Nippon Steel the world's third largest steelmaker measured by crude steel output, producing more metals abroad than in Japan. Japanese steel production capabilities are world-class, and Nippon's bid is a testament to an attractive U.S. market and investment targets.

In major foreign investment transactions, it is natural to think about issues beyond those strictly related to business. Few can argue lawmakers and federal agencies are wrong to raise national security concerns. U.S. Steel is a "critical piece of America's defense industrial base," said Sen. J.D. Vance, Republican of Ohio. Now, he fumed, the Pittsburgh company is "being auctioned off to foreigners for cash."

Japan, however, is a staunch U.S. ally, one that sits on China's doorstep. The two countries' economies and national interests are so closely intertwined that the U.S.'s efforts to fend off competition from China inevitably involve Japan's cooperation.

Japanese manufacturers loom large in global supply chains. Companies like Tokyo Electron build machine tools essential for semiconductor manufacturing, making them critical players in Washington's effort to limit China's access to high-end chips.[1] Boeing has for decades relied on components made in Japan, which make up more than a third of the 787 aircraft.[2] Apple's iPhones contain numerous Japanese components.

Japan is also a huge — and growing — buyer of U.S.-made military equipment, while owning a big chunk of America's national debt through its Treasury securities holdings, currently worth $1.2 trillion.[3]

All of which raises questions for U.S. policymakers: Might the U.S. better withstand Chinese competition with a bit more of its industrial production in the hands of Japanese managers? The question is particularly relevant in the steel industry, where Chinese companies, with their subsidies-fueled overcapacity, have threatened the viability of their competitors globally with floods of cheap products. Last year, China accounted for 54% of the world's crude steel output. Six of the world's 10 largest steelmakers are Chinese.[4]

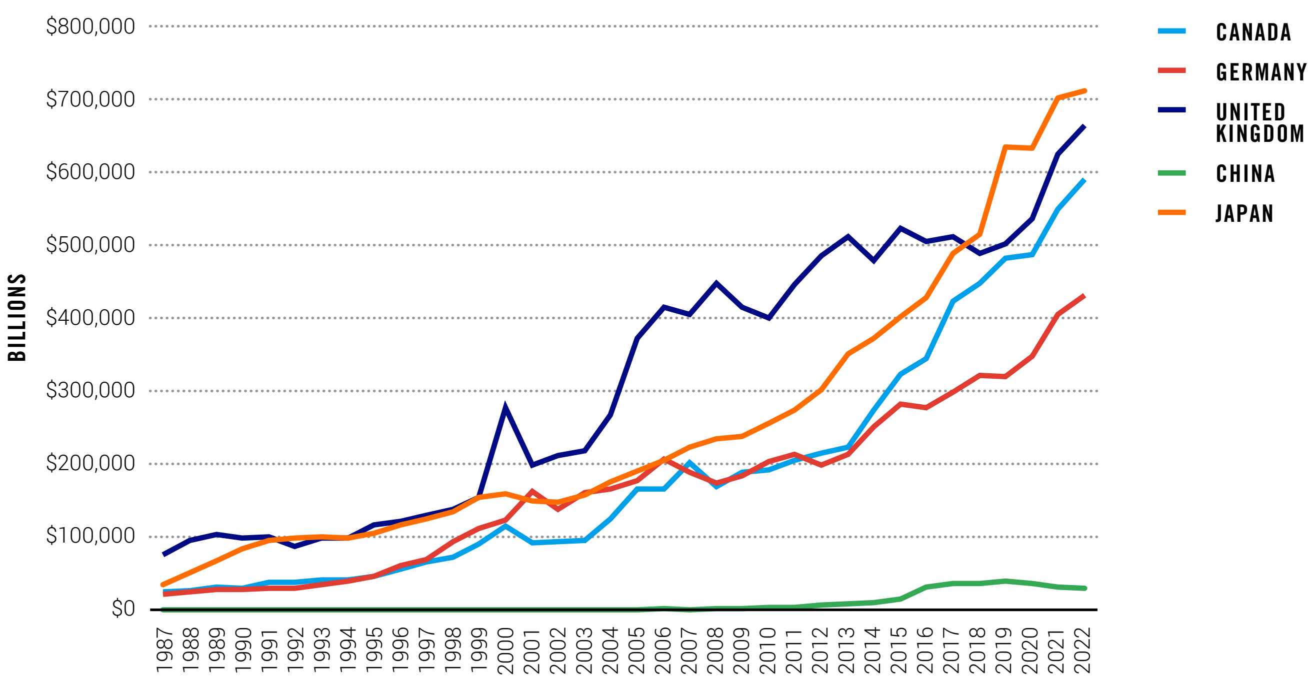
A final decision on Nippon Steel's bid will come in the months ahead, an outcome that makes Japan a test case of U.S. commitment to its free market principles and its allies: Will the U.S. embrace the exceptionally fortunate position it occupies in the world as the prime investment destination? Or will protectionism — often tied to short-term political gains — undermine those advantages?

GROWING ABROAD WHILE SHRINKING AT HOME

Japan has a significant stake in the outcome, having surpassed Britain in 2019 as the single biggest provider of foreign direct investment in the U.S. and its lead has widened since. Japanese companies' cumulative investment in U.S. factories, warehouses, and research labs totaled $712 billion at the end of 2022, and today they employ nearly a million Americans.[5]

But this comes as Japanese industries, particularly technology and finance, are falling behind their global competitors. The number of Japanese companies on Fortune's Global 500 list fell to 41 last year, from 149 in 1995. This year, the International Monetary Fund estimates

FIGURE 1: FOREIGN DIRECT INVESTMENT IN THE U.S. BY MAJOR COUNTRIES



Source: Bureau of Economic Analysis, U.S. Commerce Department
Data: rb.gy/w1ibb0

Japan's GDP per capita will amount to $33,140, a far cry from the U.S.'s $85,370 and Germany's $54,290.[6] That is a result of a sharp slide from Japan being the world's second highest per capita GDP in 2000 to No.18 in 2010, and then to No. 34 in 2023 — behind South Korea and Spain.

And yet, during that same two-decade period, Japan's cumulative FDI in the U.S. grew from $132 billion in 2000, to $252 billion in 2010 — and then surged to $695 billion in 2022, according to Japan External Trade Organization.[7]

HOW JAPAN BECAME THE NO. 1 U.S. INVESTOR

The Japanese post-war economic "miracle" drove exports of autos and electronics to the U.S. from the 1960s. By the 1980s Japan's manufacturers were seen as "flooding" the U.S. markets, and soon faced an American outcry of protectionist sentiment.

In 1981, Japanese automakers agreed to a "voluntary" export restraint program that continued through 1994. Within a decade, U.S.-bound auto exports from Japan fell to less than a third of the 1986 peak of 3.5 million vehicles per annum.[8] Steelmakers had already faced similar export restrictions starting in the 1970s.

The environment was also hostile to Japan's electronic sector. In 1987, the Reagan administration imposed 100% tariffs on Japanese memory chips, and several lawmakers smashed a Toshiba radio with sledgehammers on Capitol Hill. Fujitsu's 1986 attempt to acquire U.S. high-tech pioneer Fairchild Semiconductor was thwarted by opposition from politicians citing national security concerns.

The controversial deal helped to elevate the role of the Committee on Foreign Investment in the U.S., or CFIUS, an interagency group reviewing Nippon Steel's acquisition of U.S. Steel.[9]

Facing significant opposition amid a surging trade surplus, Japanese companies stepped up U.S. investment in the 1980s, led by automakers building factories to feed a growing American preference for their affordable, quality vehicles.

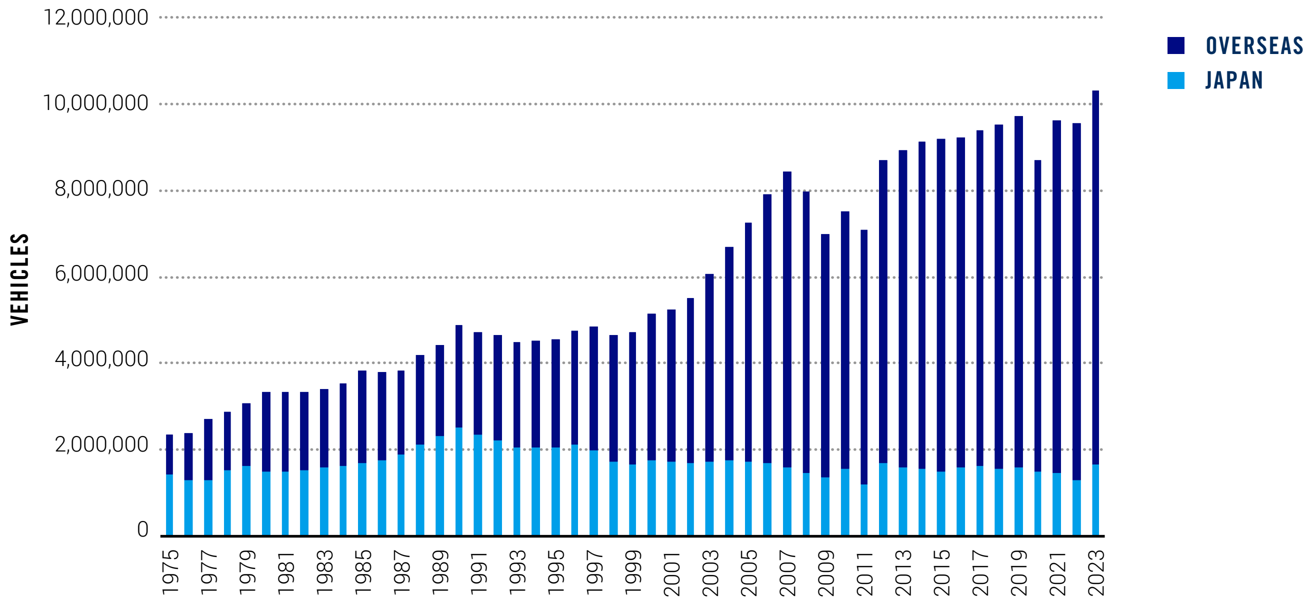
Honda, having introduced the Civic compact in 1973, became the first Japanese automaker to assemble cars locally, with production of the Accord at its Marysville, Ohio plant in 1982.[10] Toyota set up a joint venture with General Motors in 1984 in Fremont, California, and started building Corollas in 1986.[11]

Japan's manufacturers continued to shift their production overseas in the following decades even as its economy struggled after the bursting of a property bubble in the early 1990s and the ensuing banking crisis. Fueling the trend is the yen's strength, which made Japanese products more expensive and less competitive overseas and reduced exporters' profits when they were converted back into yen. By 1996, they were producing more products overseas than they exported from Japan.[12] As companies opened advanced plants in the U.S., China, and Southeast Asia, they closed outdated factories in Japan built during the postwar growth era, improving their overall efficiency.

CHASING GROWTH

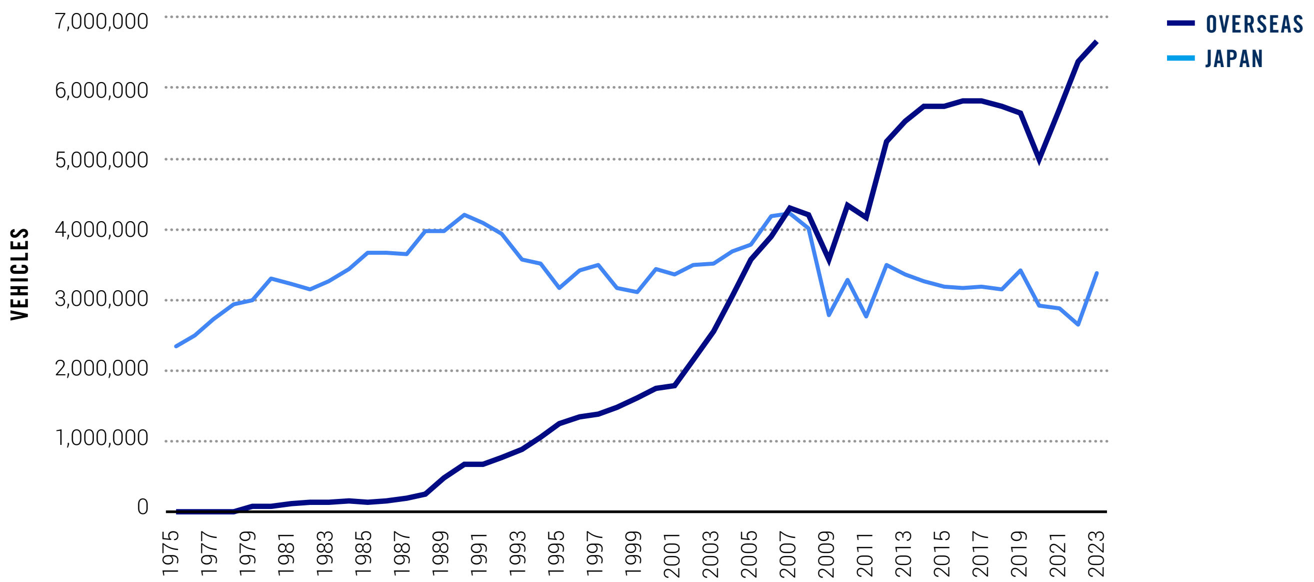
Demographics have now joined these economic reasons for overseas investments. After peaking in 2008, Japan's population has been shrinking with elderly citizens each year making up an increasingly large share of the total. The Japanese government projects the country's population will fall to 87 million by 2070 from 126.6 million in 2020, equivalent to losing California's population.[13]

FIGURE 2: WHERE TOYOTA SELLS ITS VEHICLES



Source: Toyota's annual sales and production results in Japan and overseas. Company data, in number of vehicles https://www.toyota-global.com/company/history_of_toyota/75years/data/automotive_business/production/production/japan/production_volume/index.html

FIGURE 3: WHERE TOYOTA BUILDS ITS VEHICLES



Source: Toyota's annual sales and production results in Japan and overseas. Company data, in number of vehicles https://www.toyota-global.com/company/history_of_toyota/75years/data/automotive_business/production/production/japan/production_volume/index.html

Combined with sluggish wage growth in recent decades, demand for everything from housing, cars to snack food has been shrinking in Japan. The downturn is likely to intensify. That has pushed Japanese companies, big and small, to expand abroad if they can compete.

Take Toyota. In 1990, the automaker sold 2.5 million vehicles in Japan, roughly the same volume as it sold abroad. By 2023, Toyota's domestic sales had fallen to 1.7 million, while its overseas sales had grown to 8.6 million.[14]

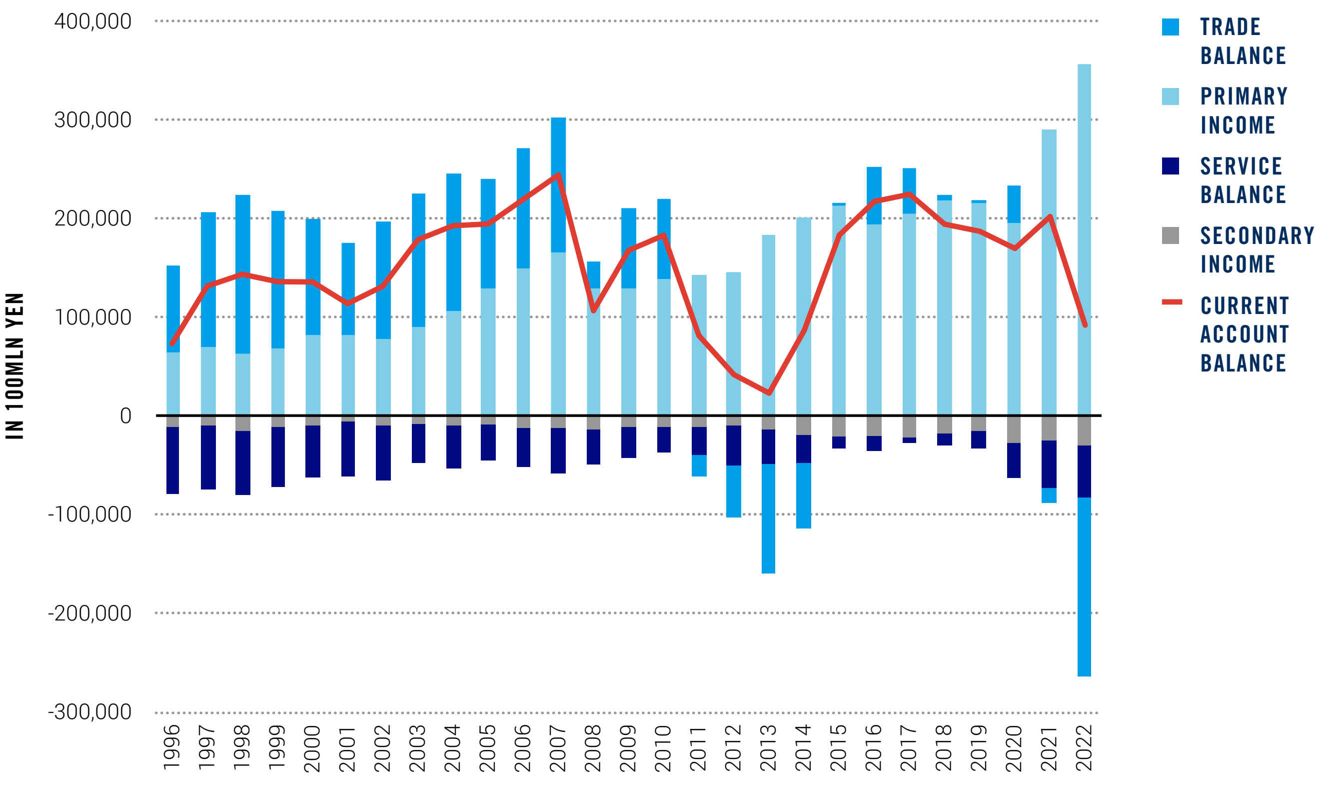
Toyota now mostly builds where it sells. The company's production in Japan hit a high of 4.2 million vehicles in 1990, nearly 90% of its production worldwide. Last year, factories in Japan made only a third of Toyota's global production of 10 million vehicles. The automaker accounts for one in nine vehicles built worldwide.[15]

Overall, Japanese manufacturers are projected to earn 39% of their revenues outside of Japan during fiscal 2023, up from 29% two decades ago, according to a survey of 534 companies by Japan Bank for International Cooperation, a government lender. The companies planned to manufacture 36% of their products outside of Japan, compared with 26% in fiscal 2003.[16]

DETERIORATING TRADE BALANCE

Some of the largest acquisition deals by Japanese companies reflect a singular strategy to chase American consumer demand. The $21-billion acquisition of gas station chain Speedway by Seven & i Holdings, a Japanese retail giant, is among such examples. The $16 billion acquisition of spirits maker Beam by Suntory, its former Japanese competitor, is another.

FIGURE 4: JAPAN'S CURRENT ACCOUNT BALANCE



Japan's macroeconomic flows reflect its companies' behavior. In its current account data, the primary income surplus — made up largely of profits, interest and dividends from overseas investments — grew from 7.8 trillion yen in 2002 to 36 trillion yen ($270 billion) in 2022, a surge resulting from both investment expansion and the dollar's recent rise against the yen.

Meanwhile, the country's trade balance, once the source of friction with the U.S., deteriorated from a surplus of 12 trillion yen in 2002 to a record deficit of 18 trillion yen ($138 billion) in 2022, which in part reflected higher import costs of energy and food.[17]

"Japan is transforming into a country that earns its keep from investing money abroad," writes Masaya Sasaki, a Nomura Research Institute economist. "It's no longer a country that earns money by making goods at home and selling them overseas."

Sasaki notes that the change may reward Japanese multinationals and their shareholders, but not their workers and suppliers in Japan and the country's overall growth potential.[18]

WHAT NIPPON STEEL SEES IN U.S. STEEL

Nippon Steel may not be a household name in the U.S., but it's hardly a newcomer. Like many Japanese manufacturers, it arrived in the U.S. with modest investments in the 1980s to escape trade barriers, followed by a steady buildup in the following decades. Now the steelmaker, known for its cautious corporate culture, has launched a high-stakes acquisition bid to remain a top global player.

Nippon Steel is an iconic symbol of Japan's industrial might, just as U.S. Steel is for Americans. The two companies share striking similarities. A predecessor of Nippon (Nippon means "Japan" in Japanese) began producing steel at its first modern furnace in 1901, the year U.S. Steel was founded by J.P. Morgan and Andrew Carnegie. The two companies fueled the industrialization of their respective countries in the early 20th century, and both were critical suppliers of steel to their militaries during World War II.

The U.S.-led occupation forces broke up Nippon Steel into smaller companies, but by the early 1970s, it regained its size through mergers and acquisitions to rank among the world's largest steelmakers, including U.S. Steel.[19]

'STAR WARS'

In the 1980s, Nippon, along with other Japanese steelmakers, were invited to invest in the U.S. to help modernize their struggling American counterparts — a reward for agreeing to "voluntarily" curb their exports.

Nippon's first foray into the U.S. came in 1984 with a technical assistance agreement with Inland Steel, a Chicago company hobbled by spiraling labor costs to respond to union demands, outdated facilities, and competition from Japanese and German companies.

Visiting Japan that year, Inland executives marveled at Nippon's computer-controlled plant, calling it "the answer to the maiden's prayer." Soon, an Inland-Nippon joint venture built two factories near South Bend, Indiana to make sheet steel for automobiles. They were modeled after the state-of-the-art Japanese plant that the Americans had dubbed "Star Wars."[20]

Nippon, long a top maker of high-end automotive steel sheets, acquired a German-owned modern factory in Calvert, Alabama in 2014, jointly with Luxembourg-based ArcelorMittal. This made the company a major supplier of sheet steel to

Japanese and other automakers located in the South. A $775-million expansion plan is underway at AM/NS Calvert with 1,700 workers.

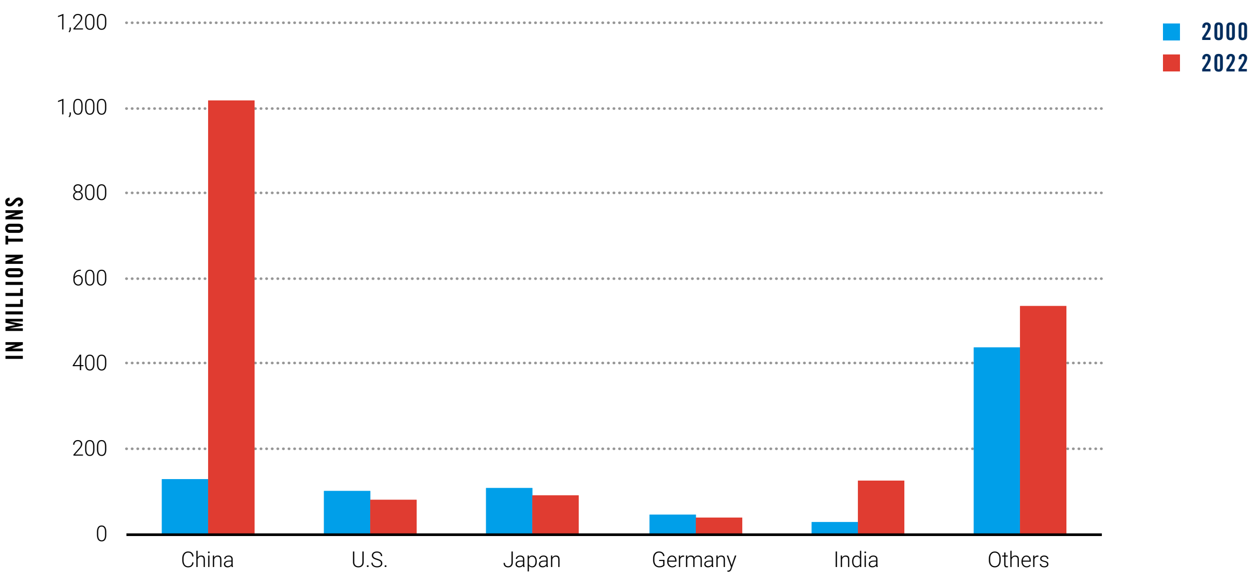
The company has faced challenges. Its 1983 attempt to acquire the specialty metals division of Allegheny International was blocked by the Defense Department citing the risk of technology leakage to the Soviet Union. Nippon, along with other Japanese steelmakers, has repeatedly tussled with U.S. trade officials in anti-dumping cases.

Nippon has recently been on a shopping spree worldwide. Through a joint venture with ArcelorMittal, Nippon has invested billions to expand a giant mill in India acquired in 2019. Other new locations are in Thailand, Sweden, and Brazil.[21]

Adding significant capacity in the U.S. is part of the company's strategic blueprint unveiled in 2021, which called for increasing its annual global production capacity to 100 million tons from 66 million tons in 2023. In Japan, the plan envisioned closing five of its 15 furnaces and eliminating 10,000 jobs.[22]

Like other global steelmakers, Nippon has grappled with growing Chinese competition. Helped by government subsidies, Chinese companies like Baoshan Iron & Steel have expanded aggressively and flooded the world with cheaper steel. The quality of Chinese steel has also improved. Western rivals accused them of intellectual property theft.

FIGURE 5: WORLD CRUDE STEEL PRODUCTION 2000 VS 2022 (MILLION TONS)



Source: World Steel Association.
https://worldsteel.org/data/world-steel-in-figures-2023/#major-steel-producing-countries-%3Cbr%3E-2021-and-2022
https://worldsteel.org/wp-content/uploads/2011-World-Steel-in-Figures.pdf

Sending a shock wave through Japan's business community, Nippon Steel filed a lawsuit against Toyota in 2021, accusing its longtime top client of patent infringement over its use of steel sheets for EV engines supplied by Baoshan. Nippon, which also sued Baoshan, later dropped the lawsuit.[23]

Nippon, which announced the proposal for its $14.1 billion acquisition of U.S. Steel in December, pledged to honor existing labor agreements with the United Steelworkers union, retain U.S. Steel's name, and keep its headquarters in Pittsburgh.

"U.S. Steel will remain an American company," the two companies said in a statement on April 17 after President Biden, speaking to union workers in Pittsburgh, reiterated his opposition to the deal.[24]

On April 23, U.S. Steel's shareholders overwhelmingly approved its sale to Nippon Steel as the "best path forward." The company noted the merger will make it and the American steel industry stronger and more competitive in the face of unfair competition from China.

WHAT COMES NEXT

The Nippon Steel-U.S. Steel merger proposal is a very public example of a broad phenomenon that offers many benefits to both Japanese firms and the American economy. Japanese businesses are likely to continue investing in the U.S. Its population decline will only cause the shrinking of the home market to accelerate. And like peers from Europe and Asia, many Japanese companies are rushing to take advantage of tax credits and subsidies of the Inflation Reduction Act and the CHIPS and Science Act.

The poll by JBIC, the Japanese government bank, showed that more than half (53.3%) of the surveyed companies had concrete plans to start or expand investments in the U.S. in the coming few years, even as they cited concerns about inflation and rising wages. That ratio is higher than 45% for China and India, other top Japanese investment destinations.[25]

The yen's steep decline since 2021 — triggered by the widening interest rate gap between the U.S. and Japan — has lowered the relative cost of manufacturing in Japan. That has encouraged big global chip makers like Taiwan Semiconductor Manufacturing and Micron to invest billions of dollars in Japan as they sought to diversify production away from China.

And the weak yen — which in late April hit a low since 1990 — has some Japanese manufacturers taking a new look at investing again in their home country. But a major reversal in the shift in production overseas is unlikely. More than two in three companies plan to boost operations overseas in the next three years or so. Only 47% plan to expand in Japan, the lowest level since 2020.

During his trip to the U.S. in April, Japanese Prime Minister Fumio Kishida avoided any confrontation with President Biden over the Nippon Steel deal. Instead, he underscored Japan's role as the No. 1 investor in the U.S. and toured Toyota's new EV battery factory site and Honda's aircraft plant in North Carolina.

"We believe in U.S. leadership, and we also believe in the U.S. economy," Kishida said. He predicted that Japan's investments in the U.S. "can only increase upward in the months and years to come."

CONCLUSION

The outcome of the Nippon Steel-U.S. Steel deal is uncertain. So are the prospects for the future investment relations between the U.S. and Japan. Some worry American policymakers' actions — increasingly driven by economic populism and nationalism among voters — will cause foreign investors' appetite to sour.

But rather than abandoning the deal, Nippon Steel has stepped up its campaign to win the support of policymakers, posting patriotic ads at Washington bus stops and at Dulles airport. No other Japanese companies have publicly cited Nippon's experience as a reason for curtailing their investment plans.

This much is clear: Nippon's emergence as a bidder for a prominent American manufacturer is an inevitable outcome of a changing economic landscape. In the past, Japanese companies came to the U.S. to build factories to escape the impact of trade friction and currency appreciation.

Now they are doubling down because there is no longer enough demand at home to support their growth. The U.S. is where they see opportunities.

All of this will yield significant benefits for the American economy and workers should the U.S. welcome foreign investment by friendly nations like Japan. Washington should, of course, carefully screen investors to protect American jobs and address the risk of critical technology ending up in the wrong hands. CFIUS should be enhanced and strengthened to accommodate what is highly likely to be growth in inbound FDI. Already, CFIUS is seeing its caseload surge, with the number of filings rising to a record 440 in 2022 from 249 in 2018.[26]

But such necessary precautions should facilitate, not undermine, the potential rewards. More FDI will bring to American communities - often in rural areas and the Rust Belt - new jobs and additional investments from suppliers. The beneficiaries, in particular, will be American workers without college degrees, who tend to reap greater rewards from good manufacturing jobs. Increased FDI will also mean more of the funding and innovative know-how the U.S. will need to improve productivity, reduce reliance on imports and withstand competition from China. That's particularly true for the steel industry where companies have struggled with Chinese overcapacity even as they face enormous pressures and funding requirements to shift to greener technologies.

The Biden administration's own "friend-shoring" strategy calls for closer ties and cooperation with allies and like-minded countries. The goal is to strengthen supply chains for critical products in order to strengthen national security and respond to future emergencies. It is difficult to see the wisdom of any response to Nippon Steel's bid short of embracing the vote of confidence in our marketplace that the Japanese company's proposed transaction represents.

Companies in other countries — each with their own aging populations — are watching.

Note: In the second installment of this research project, we will examine the impact of foreign investment on the U.S. economy and why Japan remains a formidable force.

ABOUT THE AUTHOR

Yuka Hayashi is a senior fellow at the Progressive Policy Institute. She was a journalist at the Wall Street Journal for two decades, most recently covering U.S. trade and economic policy from Washington. Previously, she was a Journal correspondent in Tokyo, where she wrote about Japan's economy and East Asian geopolitics.

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