The PRD [*Pearl river delta*] is exporting jobs but producing more goods for the home market

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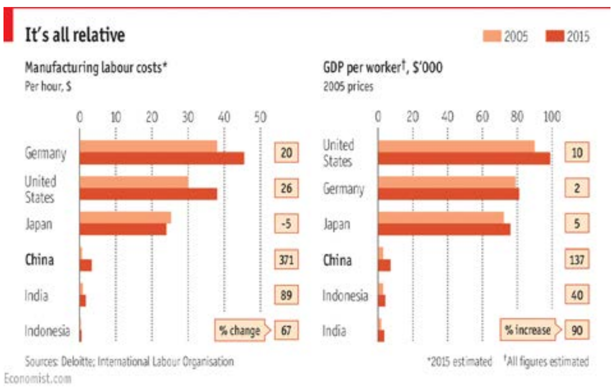
“The Great Convergence”, a recent book by Richard Baldwin, argues that throughout most of the industrial era the know-how and culture essential for high-end manufacturing remained cloistered in the factories of the rich world. That led to a divergence between the fortunes of the West and the rest. But once the cost of communications started plunging, after 1990, such knowledge flowed more freely. Western multinationals built world-class factories in remote places, unpacking and outsourcing their manufacturing operations and supply chains.



China was one great beneficiary of this process. The developed world’s industrial knowledge and the PRD’s low wages created an unbeatable combination. Vast quantities of well-made but affordable goods were shipped from the delta’s factories to meet the seemingly insatiable appetites of the rich world. So the other great beneficiary of this axis of efficiency was the consumer in the West.

Now the axis is looking wonky at both ends. Labour shortages and increases in minimum wages have pushed up manufacturing salaries by a factor of four in the past ten years (see chart). They are now considerably higher in China than in South-East Asia or India. At the same time the rich world’s appetite for imports from China has been kept in check by years of stagnation, and there are now fears that its enthusiasm for free trade may be waning.

This problem faces industrial exporters across the mainland, but it is most acute in the delta. Hourly wages in Guangzhou are about a third higher than the national average. In response, the PRD’s resilient manufacturers are performing a neat pivot. They are shifting some of their manufacturing to cheaper regions nearby, and they are redirecting exports to the huge and growing mainland market. “China 2.0 has emerged,” declares Marshall Fisher of the Wharton Business School. Until about 2010, the region’s labour-intensive factories (which he dubs China 1.0) operated on labour-cost arbitrage. When wages shot up, many pundits predicted a bleak future for the delta, with factories decamping en masse to cheaper places in Asia. Instead, says Mr Fisher, the PRD’s companies diversified and adapted.

It is worth noting that despite the recent difficulties, China Inc remains king of global manufacturing. Deloitte, a consultancy, quizzes over 500 chief executives round the globe every three years to rank countries on their manufacturing prowess. In the latest report, published last year, China came top, beating America, Germany and Japan, just as it had done in 2013 and 2010.

Moreover, the delta has not been hollowed out, as some had predicted. Many firms have considered leaving, and those in highly labour-intensive industries (such as low-end textiles or shoes) have indeed left. But most firms have stayed, keeping the bulk of their operations in the delta but hedging their bets by investing in cheaper regions. Some have set up factories in cities in China’s interior, others in South-East Asia.

Such investments typically form the spokes of a wheel still radiating from the PRD. George Yeo has his finger on the region's pulse. He runs Hong Kong's Kerry Logistics, a warehousing and transport firm with a big presence in the region. There is no evidence of a wholesale exodus, he says. His clients are adding factories in places like northern Vietnam from which goods can reach the delta within about a day.

The PRD's pragmatic diversification has created a resilient regional network of production, known as Factory Asia, which reinforces rather than undermines the region's importance. The delta contains many industrial clusters, ranging from cars to lighting to electronics. The complex webs of suppliers, middlemen and skilled workers on which these ecosystems rely are unlikely to disappear from it in the foreseeable future.

Tommi Laine-Ylijoki, who manages the supply chain for the consumer business at Huawei, a Chinese multinational based in Shenzhen, emphatically rejects the idea that rising costs might force him to shift manufacturing out of the PRD. He says he did look into moving inland, but found that the cost differential was only 20-30%—and his entire supplier base is in the delta. He also wants his factories and suppliers to be close to his R&D team because he believes that "collaborative manufacturing" promotes innovation. Huawei outsources the production of most smartphones, but keeps about a tenth in-house to maintain the "touch and feel" of mass manufacturing. Given the PRD's outstanding logistics, manufacturing and supply chain, he says, "I can't think of a better place to be in the world to do this."

A treasure at home

The grand pedestrian promenade at the heart of Guangzhou feels like a modern homage to Barcelona's Rambla. On one side rises a beautiful opera house designed by Zaha Hadid, on the other is a fine museum set in a building resembling a Chinese treasure box. A rainbow of lights on the elegant Canton Tower casts a shimmering reflection on the Pearl river nearby.

It does not look like a grubby industrial city. Decades of growth have made this region wealthy. The delta owes its dynamism to legions of private companies, so this wealth has been widely spread. Guangdong has a huge middle class of avid consumers. Annual total retail sales in Guangzhou and Shenzhen are far bigger than in Hong Kong. The world's highest-grossing outlet of Sam's Club, an American retailer, is in Shenzhen.

Alibaba, China's biggest e-commerce firm, holds a giant online-shopping extravaganza, known as Singles' Day, on November 11th every year. Last year customers spent a whopping 120bn yuan ($17bn) on its shopping sites during those 24 hours, more than Americans spend on their Black Friday and Cyber Monday shopping sprees combined. Usually Alibaba hosts the event in its home town of Hangzhou, but last year it moved the Singles' Day gala (featuring Kobe Bryant, a basketball star, and lingerie supermodels from Victoria's Secret) to Shenzhen.

Guangdong spends more than any other province on Singles' Day, but there was another reason to hold the event in the province, says Chris Tung, Alibaba's chief marketing officer: his firm embraces globalisation and innovation, and Shenzhen "has always been at the forefront of China's opening up to the world and represents the spirit of forward-looking innovation".

The pivot to domestic consumption may seem an obvious move for the delta's factories, but foreign firms operating in the PRD, long fixated on export markets, were slow to respond to the rise of China's middle classes. Now they are cottoning on. Factories in the delta with owners in Hong Kong are also switching from exports to the mainland market.

Edwin Keh, an academic who previously worked as a senior procurement manager at America's Walmart, offers an explanation: "We've created this global supply chain that is very efficient at making stuff in the East and consuming in the West…but now it's pointed in the wrong direction." The PRD's shipping, transport and logistics are designed for the speedy delivery of manufactured goods from Shenzhen to Los Angeles, not Shenzhen to Xi'an. Fortunately, that is changing fast.