

DRAFT

**Remarks
Of
Neal P. Gillen
To
International Cotton Advisory Committee
65th Plenary Meeting
Goiania, Brazil
September 2006**

Three months ago, I presented to the 39th Session of the United Nations Commission on International Trade Law, an updated version of the paper I presented to the ICAC 63rd Plenary meeting in Bombay, India on the “The Enforceability of Arbitration Awards – The Cotton Industry Conundrum.” Copies of that paper are available here today. You can read the full paper at your leisure. Today, I will cover the update of the statistical data, which enumerates the problems we face, and also cover some of the underlying causes and possible solutions.

Quantifying The Cotton Industry Enforceability Problem

Considering the large volume of cotton traded in the export market each year, some 43.5 million bales with an approximate value of \$11 billion, the overall record of contract execution through payment and the timely delivery of the cotton pursuant to the terms and conditions of the contract is significant. The level or degree of defaults, however, is estimated to add approximately \$300 million to the costs of doing business each year.

Further, the additional cost limits the viability of the cotton trade and the availability of cotton in those markets with a high level of defaults. Those suppliers willing to sell in markets with an attendant risk of potential contract defaults, out of necessity, will include a risk premium in the price of cotton to offset such risk.

Currently, there are 312 parties from 55 countries in default on 337 International Cotton Association (ICA) arbitration awards totaling \$161.4 million. Further analysis of the outstanding awards indicates that the seven countries accounting for 57 percent of the defaults accounted for 31 percent of the uncollected awards.

Three countries account for 36 percent of the defaults, India – 17 percent, Bangladesh - 11 percent, and Pakistan (a non-signatory of the New York Convention) – 8 percent. The next highest levels of defaults are in Indonesia and Brazil with each having 6 percent of the defaults, Turkey has 5 percent, and Mexico has 4 percent. This is a recurring problem for these countries, which have shown little or no improvement in their performance since 1999. Seven (7) other countries no longer have parties listed in default and 15 countries show no change since 1999.

By comparison, in 1999 there were 164 parties from 44 countries listed in default on 188 ICA arbitration awards totaling \$60.8 million, reflecting a significant increase in defaults in the past seven years of \$100.1 million.

Between 1999 and 2006 the number of mills listed in default increased in 25 countries, led by China, where defaults increased by 89 percent. China was followed by Bangladesh's 78 percent, the United States' 70 percent through merchant defaults, Brazil's 63 percent, and India's 67 percent. In the same time period, improvement was shown in only one country, Morocco.

Analysis of the default data shows that the period from 2000 to 2002 accounted for 113 or 33 percent of the defaults amounting to \$53.4 million. In 2002 alone, 50 defaults occurred accounting for 15 percent of the total awards rendered in the amount of \$19.6 million. Mills in India were the primary defaulters as 21 mills failed to honor ICA arbitration awards, representing 42 percent of the defaults in 2002 - the highest number of defaults ever recorded in a single country in any given year.

The level of defaults in 2002 is attributed to the precipitous price decline occurring in the 2000-02 marketing year when cotton prices fell from the 60-cent range in January of 2001 to the 30-cent range in the ensuing 9-month period.

Factors Contributing To Defaults

Since a majority of the defaults are occurring in relatively new markets it is obvious that a number of factors can define the problem, including cultural and ethical issues ingrained in business practices or customs regarding contractual obligations, particularly in the yarn-spinning sector, restrictions on hedging and currency transactions, and a lack of familiarity with international trade rules and arbitration procedures.

The yarn-spinning sector is a particular concern since a rule-based structure is virtually non-existent in the world yarn trade. Therefore, a merchant finds himself selling to a yarn spinner under a well-established and respected set of trade rules while the yarn-spinner is selling into a predatory market lacking the rules and ethical standards common to the raw cotton trade. In a declining market the yarn-spinner is almost certain to experience defaults on his high priced yarn sales. This being the case, it is highly likely that he will default on his high-priced purchases of raw cotton. In the countries with the highest level of defaults, particularly India and Pakistan, most of the mills in default are yarn spinners.

Restrictive currency regulations inhibit hedging and in some cases there have been outright prohibitions against hedging. In the seven countries that account for 53 percent of the defaults there are laws and/or regulations to that effect. In recent years, India has begun to reform its currency regulations while Mexico and Turkey have lowered barriers to currency transfers. In Bangladesh, Brazil, Indonesia, and Pakistan it is either not permissible to hedge commodity purchases in the futures market or the currency restrictions preclude such action.

Of particular importance to our discussion today is the lack of familiarity with international trading rules and arbitration procedures along with the consequences of failing to comply with these universally acceptable precepts. As our problems emanate in the developing countries where textile production thrives, that is where our industry must concentrate its efforts in educating the players in these markets on the benefits of uniform contracts, trade rules, and arbitration procedures.

Therefore, it is imperative that those selling into these new markets acknowledge each of these factors and that individual merchants or his trade organizations consider undertaking a comprehensive and large scale educational effort to familiarize the new buyers with the prevailing trade rules, the protections and expectations of those rules – that the seller will deliver and the buyer will make payment and accept delivery with the understanding that the parties will utilize the available dispute resolution procedures when differences arise, and the additional protection of the industry's system of listing parties in default for failing to honor a contract or an arbitration award.

Such an effort cannot succeed until the trade and the mills in the countries with high levels of defaults fully comprehend and support the necessity for a rules-based system and are convinced that dispute resolution through arbitration is fair, impartial, affordable, and enforceable.

It is also imperative that those countries now actively engaged in the purchase and/or sale of cotton in the world market undertake the necessary reforms in their financial and currency regulations to permit their cooperatives, producers, ginners, merchants, and textile mills to make effective use of the available risk management alternatives that will protect them against adverse price movements.