

**REPORT  
of the  
EXECUTIVE DIRECTOR**

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to the 65th Plenary Meeting of the  
**INTERNATIONAL COTTON  
ADVISORY COMMITTEE**

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Mr. Chairman, distinguished delegates, observers and guests, thank you for the opportunity to address this 65<sup>th</sup> Plenary Meeting of the ICAC since 1939. The world cotton industry experienced unusually strong growth in consumption and extraordinary growth in trade during the past two years. Nevertheless, financial pressures on producers remain heavy, especially for those who do not receive direct support from government measures, and many textile producers face extraordinary competitive pressures from expanding industries in other countries.

In looking back at the past season, there are three major developments specific to the cotton market that are especially intriguing. First is the ease with which the cotton industry adjusted to the tripling of imports by China (Mainland). In past years, imports of 500,000 tons by any country were considered large, and imports of one million tons were considered enormous. Yet, imports by China rose to 4 million tons last season, and the market absorbed that increase with seeming equanimity. Given the magnitude of changes in quantities traded during the past two seasons, cotton prices have been surprisingly stable, and this suggests that the world cotton industry remains highly resilient and adaptive in the face of structural changes and logistical challenges.

Another striking development of the past season is that prices remained well below the long run average of more than 70 cents per pound, despite the enormous rise in imports by China (Mainland). Based on data from 1973, the Secretariat model of annual changes in the Cotlook A Index performed very well in most seasons. According to the model, net trade by China (Mainland) was the most important determinant of changes in annual prices, and imports by China of 4 million tons in 2005/06 should have driven the annual average Cotlook A Index at least as high as the long run average. However, despite the growth in world cotton trade, the Cotlook A Index averaged just 56 cents per pound in 2005/06, 15 to 20 cents lower than the level indicated by cotton market fundamentals.

The Secretariat's model of season averages of the Cotlook A Index has performed well since its introduction in 1988, and in most years forecast errors were caused by inaccurate estimates of cotton supply and use rather than weakness in the structure of the statistical model. The two variables used in the ICAC model, net exports by China (Mainland) as a share of non-China use, and stocks outside China as a share of non-China use, explained about 80% of the variation in annual changes in the A Index, and in most years the model error was less than 7 cents per pound. However, during the past season, the price model over-estimated by about 15 cents, suggesting that the relationship between prices and measures of supply and use has changed. This poses a strong research challenge for the Secretariat.

Logic and more than a decade of experience in using the model suggest that the variables used in the ICAC price model are still valid in identifying the direction of change and magnitude of change in prices from one year to the next, and the Secretariat is basing price forecasts for 2006/07 and 2007/08 on the changes indicated by the model. Nevertheless, additional empirical work is needed to better understand the reasons why cotton prices remain well below the long run average despite record imports by China (Mainland).

A third important characteristic of our understanding of the world cotton market during 2005/06 is the growth in mill use in China (Mainland), combined with rising uncertainty over the accuracy of estimates of cotton supply and use in China. China (Mainland) accounts for about two-fifths of world cotton mill use, and small percentage errors in estimates of the size of Chinese consumption can mean significant errors in the estimates of world trade. The Secretariat, and other organizations estimating cotton supply and use, rely on data on production, exports and imports of cotton and production of cotton yarn to try and infer the level of mill use and the

balance of stocks in China (Mainland). These statistics are crucially important in understanding the timing and size of imports, which in turn have an important impact on cotton prices. The government of China (Mainland) does not estimate cotton consumption directly, and so consumption must be inferred from yarn production, and this is a very inexact methodology. The government does not publish estimates of stocks either, and so stock estimates have to be inferred from behavior, an even-less accurate methodology. The statistical situation in China (Mainland) and other countries will receive explicit attention during the 3<sup>rd</sup> Open Session on Cotton Supply and Use. Increased transparency in the cotton sector of China (Mainland) would assist all market participants, and increased levels of participation in international meetings by cotton industry officials from China (Mainland) will be very much welcomed.

### **Strategic Plan**

The 62<sup>nd</sup> Plenary Meeting in Poland in 2003 directed the Secretariat and the Standing Committee to develop a strategic plan to guide the work of the Committee. The Standing Committee approved a Strategic Plan earlier this year, following discussion in the Private Sector Advisory Panel. The Strategic Plan serves as an excellent planning tool for considering major challenges facing the cotton industry and how best the ICAC can assist governments in facilitating a healthy cotton economy in light of these challenges.

Sustainable production systems, demand enhancement, government measures, contract sanctity and membership in the ICAC are the major issues identified in the Strategic Plan.

### **Sustainable Production Systems**

Sustainable production is the ability to produce cotton today without diminishing the ability of future generations to produce cotton. Sustainable production practices cannot be precisely defined because agronomic practices are highly situation specific. Nevertheless, sustainable practices are generally understood to mean agronomic systems under which farmers are able to produce cotton profitably while minimizing input use. In most cases, the knowledge necessary to implement sustainable production systems exists or can be readily developed from current technologies. The constraint to expanded implementation of sustainable production practices is a lack of knowledge by farmers, and governments can contribute through a strengthening of extension systems. Under the Strategic Plan for the ICAC, the Secretariat is charged with facilitating the development and implementation of best management practices (BMP) that result in sustainable production of cotton in producing countries.

This strategic challenge is being addressed explicitly in the theme of the 65<sup>th</sup> Plenary Meeting and during the first two Open Sessions. The purpose of each of the first two sessions is to raise awareness of the impacts of cotton production practices on the environments and people of rural areas, and to provide fact-based measures of those impacts where possible. The word "efficiency" is included in the titles of each session to highlight that there are always tradeoffs in production decisions, and that production practices associated with low-input farming systems are not necessarily better for the environment than wisely applied conventional practices. The 5<sup>th</sup> Open Session on Thursday will contribute to this discussion with a technical seminar on the topic of Sustainability: Biotechnology and Crop Management.

Cotton is highly beneficial to the economies of the countries that grow it, and the environmental and social implications of cotton production are reasonable and manageable. However, it is now apparent that many scientists and government officials made a fundamental mistake in previous decades in focusing recommendations for cotton production practices almost exclusively on the

objective of increasing yields, in many cases without regard to costs. The focus on yields has led to the development of production systems that rely on intensive applications of purchased inputs, including water and pesticides, when alternative recommendations could have achieved higher levels of sustained profitability and lower environmental and social impacts, while still achieving acceptable yields.

In many cases, the long-term consequences of high levels of pesticide use were not considered, but the lessons learned from this experience can be incorporated into new recommendations. For example, were it not for the experience with the development of resistance to pesticides, Bt cotton would probably have been introduced without a refuge requirement, and the viability of Bt technology could have been undermined by the early development of resistance. The major lesson to be learned during the 1<sup>st</sup>, 2<sup>nd</sup> and 5<sup>th</sup> open sessions of this plenary meeting is that cotton is a beneficial component of rural economies and recommendations for production practices must consider long-term consequences for the environment and impacts on people.

### **Demand Enhancement**

Competition with chemical fiber is a continuing challenge for the cotton industry, and each plenary meeting since the mid-1980s has included discussion of how best to meet this challenge. It would seem that new approaches are necessary.

Under the strategic plan, the Secretariat is charged with encouraging increased consumption of cotton at the retail level. The Secretariat is working with the International Forum for Cotton Promotion (IFCP), and their excellent executive director Jeff Silberman, to provide information to national cotton industry organizations and governments on the structure, conduct and performance of Cotton Incorporated and other successful domestic demand enhancement organizations and encourage the adoption of similar strategies. In addition, within the strategic plan, member governments are asked to specifically endorse increased consumption of cotton as a legitimate policy goal, adopt fiber-content labeling requirements for products sold at retail, and to enact legislation supportive of efforts by the private sector to raise funds through industry organizations to finance research and promotion efforts.

Unfortunately, while there is a broad consensus that demand enhancement efforts are necessary and important, there has been little progress in actually achieving an increase in demand enhancement activities funded by national cotton sector organizations, and governments have not shown much inclination toward encouragement of such activities. Accordingly, the subject of demand enhancement is being refocused this plenary meeting for inclusion as a session in the Production Conference targeted specifically toward producers. It may be time to rethink the objective of trying to encourage the creation of national cotton organizations to fund domestic demand enhancement activities, and instead redirect the work of the IFCP toward facilitating efforts by state organizations or by individual cotton companies. The session on Demand Enhancement during the Production Conference on Wednesday will provide a forum for discussion of efforts at developing demand enhancement activities within the private sector and how best such activities might practically be organized. The 6<sup>th</sup> Open Session on Friday on the Future of the South American Textile Industry will provide an opportunity for discussion of efforts to enhance mill use of cotton.

### **Instrument Testing**

Within an overall effort at demand enhancement, one area of significant progress within the ICAC and the cotton industry is the effort to encourage commercial standardization of

instrument testing of cotton. Instrument testing is not an end in itself: it is a means to an end. The objective of instrument testing is improved efficiency in the standards used to describe cotton so as to enhance its competitiveness relative to polyester and thus raise demand for cotton.

The Task Force on Commercial Standardization of Instrument Testing of Cotton (CSITC) was created following the 62<sup>nd</sup> Plenary Meeting in 2003, in order to encourage widespread use of high-quality instrument testing systems at the producer level within a standardized international testing system. Under the strategic plan, the ICAC will encourage worldwide adoption of a standardized instrument testing system for cotton by facilitating the work of the CSITC and by disseminating information about instrument testing systems. The CSITC met five times during 2004, 2005 and early 2006, and agreed to a system of international CSITC Round Trials to evaluate the performance of cotton testing centers within a standardized instrument testing system. Two Pilot CSITC Round Trials were conducted in 2005 and 2006 to test procedures for the conduct of the Round Trials and the evaluation of test centers, and actual quarterly CSITC Round Trials will begin in the last quarter of 2006. This is a major accomplishment for the world cotton industry and demonstrates the value of the ICAC as a forum for discussion in order to facilitate cooperation. It is with great appreciation that I thank Andrew Macdonald and all members of the Task Force on CSITC and other participants in CSITC activities for their work during the past three years.

With support from the Common Fund for Commodities (CFC), and with co-financing by the European Commission, the ICAC is sponsoring a project to assist developing countries to participate in the international system of standardized instrument testing. The world cotton industry receives substantial support from the CFC and its Managing Director, Ambassador Ali S. Mchumo. The support given to the cotton sector by the CFC is contributing materially to the health of the world cotton industry. The support of the EU for the instrument testing initiative of the ICAC is also much appreciated.

A full report on the work of the Task Force on CSITC and a panel discussion about the costs and difficulties of implementation will take place during the 4<sup>th</sup> Open Session on Tuesday.

### **Distortions Caused by Government Measures**

There is broad recognition that distortions to production and trade caused by government measures in agriculture reduce income and lower wealth in the aggregate. There is broad agreement that the venue for negotiation of reductions in agricultural subsidies is the World Trade Organization (WTO). The role of the ICAC in the WTO process is to inform governments about the nature and scope of distortions in cotton caused by government measures, and to raise the profile of cotton and emphasize the need to reduce government measures that distort production and trade. The First Plenary Session is devoted to the topic of Government Measures, and the time allotted to this topic has intentionally been increased in the agenda of this plenary meeting.

Under the strategic plan, the ICAC is committed to supporting a successful outcome to negotiations in the Doha Round that will result in the elimination of export subsidies, improve market access for agricultural trade and lead to reductions and eventual elimination of forms of domestic support that distort production and trade. In order to help achieve this objective, the Secretariat will continue to provide independent and objective information on the size and nature of government measures affecting cotton production and trade. In addition, the

Secretariat will work with the Standing Committee to provide a forum for discussion of subjects related to government measures during Standing Committee meetings in Washington.

At this time, the Secretariat is unable to achieve one of the strategies regarding government measures envisioned in the Strategic Plan. The Secretariat is currently unable to credibly estimate the impacts of government measures on cotton prices because of apparent changes in the structure of the world cotton market that are not yet fully understood or agreed upon. For a given level of prices, world cotton area is higher today than it probably would have been in the past. As noted earlier, the Secretariat model to estimate season averages of the Cotlook A Index has performed very well, but the residual between model results and actual prices last season raises doubts about the validity of estimates of price impacts stemming from government measures at this time. As noted earlier, this is an ongoing empirical challenge for the Secretariat.

### **Contract Sanctity**

Contract defaults impose costs on the entire cotton chain in the same way that the costs of shoplifting are eventually borne by all shoppers. A related threat to the efficient trading of cotton is that sets of rules for international trade in cotton could multiply, resulting in numerous parochial sets of rules for different regions that would reduce transparency and efficiency in cotton trade. Under the strategic plan of the ICAC, member governments agree to insist on adherence to good trade practices by all members of the cotton trade. The Secretariat is working with the private sector to publicize the negative impacts of contract defaults on world cotton trade, and it is cooperating with industry organizations to facilitate efforts to harmonize trading rules. A breakout session on this topic is scheduled for Wednesday morning to allow discussion of progress toward the standardization of contracts for international trade in cotton since the 64<sup>th</sup> Plenary Meeting last year in Liverpool.

Under the strategic plan, the Secretariat is instructed to work with the International Textile Manufacturers Federation (ITMF) and other organizations to analyze the structure, conduct and performance of both the cotton and cotton yarn industries to aid in understanding the problem of defaults on cotton contracts. The ICAC might facilitate efforts by ITMF and the International Cotton Association (ICA) to develop a model contract for trade in cotton yarn based on the ICA contract for trade in cotton. The Secretariat has yet to make progress on these strategies but will focus its efforts to ensure progress during the coming year.

### **Declining Membership**

Membership in the ICAC has fallen from more than 50 countries at its peak in the early 1980s to 40 countries presently. As noted last year, the viability of the ICAC as an institution is not yet at risk, but continued reductions in membership will eventually imperil the organization. Thus, the ICAC needs to refocus efforts at membership growth. The loss of the membership of Japan, Benin and the Philippines in recent years is disturbing. The ICAC is not alone in this concern. The issue of membership was on the agenda of a meeting at the headquarters of the Food and Agriculture Organization of the United Nations in April this year attended by representatives from most international commodity bodies (ICBs) and the Common Fund for Commodities. Other ICBs also reported challenges in maintaining the support of governments.

The arguments for continued government support for the ICAC are strong. As noted by Standing Committee delegates, the ICAC provides public infrastructure in support of the cotton industry that cannot be performed in the private sector. During the CFC/ICB meeting in Rome in

April, it was noted that international commodity bodies are political organizations that serve as instruments of cooperation between developed and developing countries. ICBs do not intervene in markets, but organizations like the ICAC influence variables that affect markets. ICBs support economic development through technology transfer and improved market transparency, and their work is of special value to developing countries. However, ICBs are more than just development agencies: the ICAC and other ICBs are instruments of cooperation and communication to the benefit of all participants in the cotton economy.

However, it was also noted at the CFC/ICB meeting that there is not an international consensus on why governments should be involved in commodity organizations, and there are increasing tendencies to narrowly compare costs to tangible benefits without considering the role of ICBs in providing public infrastructure to commodity industries. It is highly gratifying to note that the Standing Committee and the Private Sector Advisory Panel are recognizing the importance of the issue of membership and are taking steps to communicate the positive role of the ICAC within the cotton industry. In particular, during the past year, the Standing Committee formed a Task Force on Membership to begin a campaign of targeted communication to potential member governments, and this effort will be enhanced in the coming year. I also want to acknowledge efforts within the European Commission to raise awareness of the importance of ICBs in world commodity industries. The EC has indicated an interest in joining the ICAC, without exclusive competence, and such a development would be highly welcome.

Membership in the ICAC is of value to all countries that produce, consume or trade cotton. Membership provides tangible benefits in the form of increased access to statistics and technical information provided by the Secretariat. Membership in the ICAC can lead to increased funding for cotton research through the Common Fund for Commodities. Most importantly, membership in the ICAC provides the avenue for each cotton industry, including cotton textile industries, to join fully into the fraternity of cotton countries in discussions of cotton issues of international scope and significance.

The membership of China (Mainland) is of special significance to the ICAC because of the size of China in the world cotton market, and the strategic plan contains an objective of having China (Mainland) join the Committee. However, this objective will not likely be met in the near future.

Cotton industry officials and government representatives in China have indicated an interest in joining the ICAC if a certain condition is met. The Task Force on Membership considered the issue of the membership of China (Mainland) and determined that it would not be a wise precedent to amend the Rules and Regulations of the ICAC in order to accommodate the interests of a country that was not yet a member. However, the Task Force made clear that all member governments of the ICAC will warmly welcome the membership of China (Mainland), and the Secretariat was instructed to pursue opportunities for pragmatic exchange of information and cooperation.

### **Acknowledgements**

The purpose of a plenary meeting is to move forward through agreements to cooperate and improve. Plenary meetings serve as a vehicle to raise the profile of cotton, provide information crucial to decision making and to facilitate cooperation on matters of shared concern.

It is highly gratifying to note that the governments of Turkey, Burkina Faso, Pakistan, South Africa and Tanzania have extended invitations to the Committee to host future plenary meetings. The Committee has accepted the invitation from Turkey to host the 66<sup>th</sup> meeting in

2007 and Burkina Faso to host the 67<sup>th</sup> meeting in 2008, and meetings in 2009 and beyond will be scheduled.

It has been a great pleasure to work with representatives of the Government of Brazil and the Organizing Committee on the preparations for this 65<sup>th</sup> Plenary Meeting. The Secretariat has received great support from Brazil to ensure that arrangements are professional and also comfortable, and their efforts are much appreciated.

The work of the Private Sector Advisory Panel (PSAP) is contributing substantially and specifically to the effectiveness of the ICAC, and there will be a very interesting report from the PSAP during the Second Plenary Session. I want to thank John Mitchell of Cargill Cotton who serves as Chair of the PSAP and all members of the PSAP for their service. Members of the PSAP serve at their own expense, and their contributions are much appreciated. Likewise, Neal Gillen of the United States serves as the ICAC representative to the United Nations Commission on International Trade Law (UNCITRAL). Mr. Gillen represented the ICAC at an UNCITRAL meeting in New York in June where he presented a paper on contract defaults in the cotton industry. His service helps to raise the profile of the ICAC within the UN system and brings increased international attention to the issue of defaults on cotton contracts.

I also want to acknowledge the work of the Standing Committee and its officers. Sipiwe Mkhize of South Africa, Elena Cores of Spain and Bilgehan Sasmaz of Turkey worked conscientiously to ensure that the agendas of meetings were focused and relevant and that meetings of the Standing Committee were conducted efficiently. In addition, Jacob Pasgo of Burkina Faso served as Chair of the Task Force on Membership, and under his leadership the Task Force conducted open and constructive discussions about membership in the Committee and began efforts to communicate to potential members on a government-to-government basis. I also want to acknowledge Michael Keune of Germany and James Johnson of the U.S. who served as Chair and Vice Chair of the Subcommittee on Budget. The Subcommittee on Budget is an unglamorous task, but its work is necessary in providing appropriate oversight and government involvement in the management of the Secretariat.

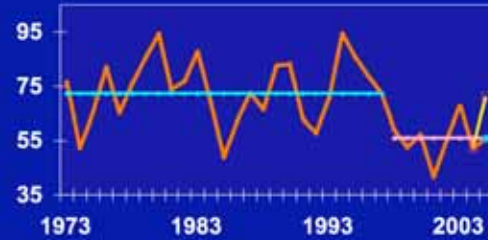
I thank member countries for the privilege of serving as executive director, and I look forward to a successful 65<sup>th</sup> Plenary Meeting.



International Cotton Advisory  
Committee

## COTLOOK A INDEX

Season-Averages in U.S. Cents per Pound



## Strategic Plan

**Government Measures**  
**Sustainable Production**  
**Instrument Testing**  
**ICAC Membership**

## Role of the ICAC in the WTO Process:

- Inform
- Raise the Profile of Cotton
- Emphasize Need to Reduce
- Facilitate Improved Coherence

## Sustainable Production

### Best Management Practices:

Optimizing Use of Purchased Inputs  
Considering long term implications of  
Production Practices

Exclusive Focus on Yields a Mistake



Commercial Standardization of Instrument Testing of Cotton

**CFC and EU Support for  
Standardized Instrument  
Testing**

**CFC: \$2 Million**

**EC All-ACP Support: \$3 Million**

**ICAC: Public  
Infrastructure**

- **Influence Variables that Affect Markets**
- **Support Economic Development**
- **Instrument of Cooperation and Communication**

**Plenary Meetings:  
Agreements to Cooperate and  
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**Raise Profile of Cotton**

**Provide Information**

**Facilitate Cooperation**

**ICAC Team**

**Private Sector Advisory Panel**

**UNCITRAL Representative**

**IFCP**

**Standing Committee**

**Secretariat**