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# VENTURE CAPITAL AND SMEs

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Entrepreneurship emerges when some of the required variables prevail in the system. Addressing issues related to these aspects is vital in the process of developing Entrepreneurship.

The theory of Entrepreneurship has been researched extensively. Bull and Willard (1993), based on a detailed review of literature in the field, have classified the entire discussion about Entrepreneurship into five broad categories. The first category is concerned with the definition of the word 'Entrepreneur'. The second category analysis the psychological traits of people identified as entrepreneurs (trait approach). Third category is the study of success strategies of enterprises. The fourth category is about studies on the formation of new ventures and the last category examines the effect of environmental factors on entrepreneurial actions.

## Entrepreneurship and Its Significance

Cantillon (1971) defined the term 'Entrepreneur' for the first time. He observed that the Entrepreneur is "someone who exercises business judgement in the face of uncertainty." Drucker (1985) defined Entrepreneurship as "an act of innovation that involves endowing existing resources with wealth-producing capacity." Leibenstein (1968) saw an Entrepreneur as "one who marshals all resources necessary to produce and market a product that answers a market deficiency."

The generally accepted meaning has been given in Webster's dictionary. It defines an Entrepreneur as "the organizer of an economic venture, especially one who organizes, owns, manages, and assumes the risk of a business." On similar lines, Oxford dictionary states that an Entrepreneur is "a person who starts or organizes a commercial enterprise, especially one involving financial risk."

While clearly classifying the processes of invention and innovation, Schumpeter (1934) placed the responsibility of economic development on entrepreneur. He observed that invention was a creative act of insight, involving a new combination of matter, a discontinuity, and a break with past, making possible the creation of a new product or a new technique to improve an existing product. Invention is the task of the 'Engineer-Thinker' while innovation is the work of the 'Entrepreneur-Businessman'. He saw the Entrepreneur as the one who changes the economy drastically.

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## Innovating Entrepreneur and Organizing Entrepreneur

Baumol (1993), however, classified these definitions by looking into their substance. He observed that one uses the term Entrepreneurship in two contexts. One refers to 'someone who creates and then perhaps, organizes and operates a new business firm, whether or not there is anything innovative in those acts'. While in the second context, the Entrepreneur is 'the innovator, the one who transforms inventions and ideas into economically viable entities, whether or not, in the course of doing so he create or operate a firm'. Accordingly, he classified the Entrepreneurs into two categories. The first category of Entrepreneur is the 'Firm-Organizing Entrepreneur' and is very close to a manager and the second is the 'Innovative Entrepreneur'.

Explaining the significance of the innovating Entrepreneurs, Baumol (1993) further stated, "It is the innovating entrepreneur of whom we think when we are concerned about economic growth and progress in productivity. For it is widely agreed that achievement in this arena is heavily dependent on constant discovery and employment of new and more effective ways of doing things and the introduction of new and better products." Schumpeter (1934) observed the function of such Entrepreneurs as "to reform or revolutionize the pattern of production by exploiting an invention or, more generally, an untried technical possibility for producing a new commodity or producing an old one in a new way"

According to Hagedoorn (quoted by Ven, 1993) the innovative Entrepreneur, possesses 'the creative labour, vision of a business idea, antagonism of non-innovative administrators, investment seduction skills to lure capitalists and risk-taking capacities to strike out into the unknown, carrying out a wide variety of innovations - be they new products or processes, product differentiation, new markets, diversifications, new raw materials, or new market structures'.

Apart from these, a host of authors have defined Entrepreneurship. Many of these definitions

are complementary rather than competitive, each seeking to focus attention on some specific feature of the same phenomenon. Still a classification of Entrepreneurs based on the innovative content involved is possible. The following part of the paper would differentiate entrepreneurial categories in terms of importance, potential impact on economies and the difficulties faced by the entrepreneurs. The proximity of Small and Medium Sized Enterprises (SMEs) to innovative Entrepreneurship is also discussed.

## Foreseeing the Future

It would be relevant to discuss the fundamental differences between the two Entrepreneurial categories, as this paper is more concerned with the innovative nature of entrepreneurship rather than firm organizing aspect (as classified by Baumol, 1993). However, a clear-cut distinction between these two types of Entrepreneurs is not simple. It is a matter of degree of newness, innovative content and unpredictability involved in a project, which make the classification possible. For example, a person who opens a duplicating or copier shop is an ordinary entrepreneur. To appraise this project for him, the time tested discount cash flow method could be applied with reasonable level of accuracy in risk estimation. But setting up a plant to commercialize an idea to manufacture duplicating machinery itself for the first time can be a 'crazy' project. Conventional appraisal tools may not be of great use here. The projected cash flows are mostly hypothetical, making the decision-making task formidable. The Innovative Entrepreneur must possess creativity and imagination in assessing the future, which is indeed an intricate task. Foreseeing the future is the character of the second venture whereas the former is a usual investment decision.

Naman and Slevin (1993), while describing the characteristics of an Innovative Entrepreneur stated that the Entrepreneurial firm is generally distinguished in its ability to innovate, initiate change, and rapidly react to change, flexibly and adroitly. An innovating Entrepreneur would act swiftly to create

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opportunities. Similarly, unlike the Firm-Organizing Entrepreneur, the potential of Innovative Entrepreneur for revolutionizing the economy is remarkable.

## Significance of SMEs

In fact, the potential of small and medium sized enterprises (SMEs) for innovation, employment creation, and contribution to economic development have been highlighted by a large number of research studies. Several countries shaped their policy framework to foster the development of vibrant SMEs in the productive system. It has been widely agreed that the comparative advantage of the USA over many other countries helped them tide over global depressions time to time and it is pertinent to note that the US has, predominantly based its strength on SMEs.

According to a study conducted by Rothwell (1985), between 1969 and 1976, firms/establishments employing less than 20 people created 66 percent of all new jobs, half of which were created in independent firms in the United States. The same study also revealed that companies that are less than five years old and employ fewer than 250 people employed almost 70 percent of total workforce. In India, almost two-thirds of the employments in the industrial sector were generated by small enterprises (Juneja, 1995).

While discussing the financing of small-scale enterprises, Pandey (1996) described the economic importance of the small-scale sector in India. A significant increase in the number of small scale units have been recorded (from 0.42 million in 1973-74 to 1.83 million in 1989-90 to 2.2 million in 1992-93), as well as significant gain in the value of production (from Rs. 72 billion in 1973-74 to Rs. 931 billion in 1989-90, at current prices), value of exports (from Rs. 3.93 billion in 1973-74 to estimated Rs. 177.8 billion in 1992-93), employment (from 3.97 million in 1973-74 to 13.4 million in 1992-93), and investment (from Rs. 22.96 billion in 1973-74 to over Rs. 100 billion in 1989-90). The small-scale sector contributes about 50 percent of the manufacturing

sector's gross value of output as well as value added and has a share of 25 percent in India's total exports.

A comprehensive study conducted by the US Government Accounts Office (1982), found that the experience of 1,332 companies started with venture capital backing, demonstrated immense benefits to the nation's economy and productivity in terms of employment generation, corporate tax, and exports. Interestingly, these benefits were disproportionately large when compared with the size of capital invested. This fact, therefore, underlines the potential of small and medium enterprises.

Similarly, there has been a correlation between innovation and the size of the firm. A study by Rothwell (1985) observed the innovational potential of SMEs in U.K. The study that covered a period from 1945 to 1983 established a strong relationship between the size of the firm and the number of innovations taking place. It found that the smallest class of firms of all, in terms of size, with an employee strength below 200 people, brought out 17 percentage innovations where as the largest firms where more than hundred thousand persons were employed could bring out only 13 percentage of innovations. The correlation between the innovativeness and the size of the firms has been documented in many researches. Studies by Cooper (1984) and Prakke (1988) have established that small firms have a good record in innovations, especially in the fields of micro processing, biotechnology, home computers, software, and new materials.

The same study of Rothwell (1985) also suggested that there were some inherent advantages for SMEs over its larger counterparts. Small firms are in direct contact with the users of their products. This direct linkage coupled with organizational flexibility has significant implications on innovation in product/process development and delivery/distribution development.

## The Prerequisites of Entrepreneurship

It is important to note in this context that the Entrepreneurship process does not flow

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automatically. Certain preconditions are required for nurturing and developing Entrepreneurship. It has been observed that there are certain critical variables, which lead to the emergence and establishment of entrepreneurship. Prevalence of these variables was the reasons for growth of Entrepreneurship. Bull and Willard (1993), state that, a person will carry out a new combination, causing discontinuity, under the following conditions.

- i. Task related motivation
- ii. Expertise
- iii. Expectation of personal gain
- iv. A supportive environment

The first three conditions are generally individualistic in nature whereas the fourth one is related to the entrepreneurial infrastructure prevailing in the economy. According to them the fourth variable, which can be either supportive or obstructive influences Entrepreneurship development.

The forces that potentially stimulate the growth of new firms in an industry are new technology, new markets and de-regulation or shift in government regulation. Variables like environmental conditions, market forces, government policy, life cycles, and innovation could play important roles in the growth of new firms. Changes in the environment precede and were causally related to 'new combinations' and 'discontinuity' in the studied industries.

The relevance and significance of infrastructure for entrepreneurship has been rightly highlighted by Ven (1993), who put forward the required industrial infrastructure components as follows: **Institutional arrangements**, such as legitimation (creation of trust), governance (norms, rules, regulations, laws), and technology standards; **Resource endowments**, such as scientific/technological research, financing and insurance arrangements, and human competence pool (training and accreditation) and **Proprietary functions**, such as technological development functions: R&D, testing, manufacturing, marketing innovation network/resource channel activities, appropriation of common good (science, financing,

labor) vendor-supplier-distributor channels, market creation and consumer demand.

Similarly, new ventures face challenges during inception. Stinchcombe as quoted by Bull and Willard (1993) terms this as 'liabilities of newness.' The challenges are the result of lack of role models, standardized communication channels, trust, and credibility, or the absence of an established clientele. While emphasizing the crucial role of support networks in the entrepreneurial process, Aldrich (1989) wrote, "with in complex networks of relationships, Entrepreneurship is facilitated or constrained by linkage between aspiring Entrepreneurs, resources, and opportunities." In the context of infrastructure Ven (1993) concluded, "that an infrastructure for Entrepreneurship includes the development of resource endowments of basic knowledge, financing mechanisms, and competent labour, as well as an institutional governance structure that legitimizes, regulates, and standardizes the activities of industry members". Porter (1980) has named them as "externalities."

In the context of such externalities, it is imperative to consider the macro-economic aspects. While emphasizing the significance of macro-economic framework for economic development Wellons (1986) stated, "It was generally believed that monetary and financial development was a consequence of real development. However, an increasing number of economists now believe that development of the monetary and financial sector is a prerequisite for the development of real economic activity." Consequently, many countries paid adequate attention in this direction. Growth of financial intermediaries such as commercial and investment banks, and more specialized and innovative intermediaries such as venture capital, leasing and contractual savings institutions and investment trusts of countries were a result of this.

### **Venture Capital – A Different Source of Finance**

The significance of SMEs is due to their potential for innovation, employment generation at

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low cost, backward area development, decentralized production system etc., and is indisputable. Nevertheless, there are many disadvantages for small firms compared to large firms. Interestingly, financial resources act as a major impediment for small firms. Although it is a part of the ideal industrial infrastructure, availability of adequate finance has been considered to be the most crucial requisite for developing Entrepreneurship. In addition, it is also important to provide the supporting system as well as to generate SMEs in the productive system of the economy. In this context, Rothwell (1985) pointed out the major problems faced by SMEs as follows:

- Entry into foreign market is unaffordable
- Utilization of experts and developing sophisticated R&D facility is beyond its means and scanning external information is too expensive to afford
- Availing capital for financing of risk projects, especially innovative projects is difficult
- It is very difficult to raise resources for exploiting the advantages of economies of scale and for financing growth
- Due to its poor networks and resources it is difficult to handle complicated procedures of patent rights and government regulations

Similarly, 'liabilities of the newness' explained by Stinchcombe also deserve attention. It directly points to the problems of identity and acceptability that SMEs face, being new in the existing set up. It has been obvious that many disadvantages experienced by new entrepreneurs are directly the result of lack of finance, although finance does not solve all their problems. Apart from the resources, new firms face the lack of management expertise, credibility, networks, and contacts.

Innovative and small firms invariably fail to attract traditional sources of finance predominantly for the following reasons.

- Traditional financiers' investment is based on collateral of the investee companies, which many such companies would not have

- Success of a new enterprise is highly unpredictable and dependent on many variables
- Traditional financiers' do not possess the required analytical skills to appraise such project
- Though the projections with a high estimation risk are available in a few numbers of cases, many firms would have negative cash flows initially for many years and hence would not be able to meet the repayment schedule of traditional financiers

Development capitalist such as state owned financial institutions might provide some resources with relatively less credit orientation. However, it fails on two accounts. First, it does not extend adequate finance and secondly does not provide crucial inputs for effective planning and monitoring of assisted firms (expertise sharing), which the new firms lack.

Similarly, the capital leasing organizations, would also find this customer unacceptable. In a large number of cases the requirements of capital assets would not be a major portion of the total requirements. Rather, the initial development cost (seed level research, prototype development, market testing, early commercialization, etc.) and working capital would be the major components of the entire capital need. Capital leasing companies are predominantly interested in owning and leasing capital assets with a view to gain out of taxation advantages and other privileges. Hence, this would not be a profitable proposition for them. In addition, the capital asset lessors also do not possess expertise to appraise such innovative and technical projects.

Another alternative, i.e. raising resources from capital market is virtually ruled out for SMEs. The reasons for it are:

- i. Lack of credentials like past track record to convince the investing public
- ii. Unacceptable and stringent listing requirements of stock exchanges
- iii. High issue cost

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- iv. Uneconomic issue size
  - v. Discouraging attitudes of society towards new ventures

In this context, a new venture has to look towards other available sources of finance. However, options are limited to government's technical financing schemes and venture finance. As several countries give greater thrust to developing independent venture capital companies through various policies, the option ultimately is limited to venture financiers. A mutually beneficial contract between a venture capitalist and a promoter could provide the suitable option.

Analyzing the historic developments in specialized financial institutions, a study of the Organization for Economic Co-operation and Development (OECD, 1986) states that the venture capital industry started and developed as an institutional response to rapid changes in the industrial sector and, in particular to the emergence of small and medium-sized companies. Venture capital targets mainly smaller and younger companies, primarily during their early stages when they are developing new products and/or services. The risks inherent to these early stages of operations make them generally unacceptable to the traditional commercial lending institutions.

Venture capital is not merely a financial solution for the young and fast growing enterprises, instead, in many cases it is management support coupled with finance. This peculiar source of finance has been capable of addressing a majority of the issues mentioned in the preceding paragraphs. Bovaird (1990) explained the peculiarities of this source of finance as; "Venture capital is essentially a form of company finance and as such is an alternative or complement to other forms of finance. However, what distinguishes venture capital from other forms of finance is that it is equity based, more participatory, with a longer term to maturity."

A related view of Harrisson (1990) put forth three major differences of venture capital from traditional equity investments as:

- i. The former exhibit higher invested capital to total capital ratios (especially when accounting for human capital as an in management support systems) than latter
- ii. Venture capital investments characteristically carry higher risks than traditional investments due to the unsecured nature of the 'loan' and the 'untested' nature of the product
- iii. Unlike traditional financiers, the investment expectations of the venture capitalist are not long run maximization of earnings, rather a maximization of short term capital gains; although profit maximization is the usual assumption for private sector endeavors, public venture capital programs may also have another long-term charge, namely, economic and regional development through the creation of new jobs

### **Venture Capital and Value Addition**

The venture capitalist extends the firm's production possibility frontiers by taking part in strategic and tactical planning and operations of the firm. Since the venture capitalist himself is an Entrepreneur, the inputs that he delivers in planning are of immense utility. In this context Lam (1991) says, "A venture capitalist usually specializes by industry or product market. His appreciation of the industry or product market and the technology required to gain the competitive edge, adds value to the firm by extending its production possibility frontier."

Similarly, the screening process adopted by the venture capitalist is deep and multi-staged. A large number of proposals would be rejected at different stages of selection. Therefore, a venture capitalist's decision to co-operate with the Entrepreneur could be considered as a signal of firm quality. This is significant for Entrepreneurs who have to approach the banks for further resources. It provides the credibility and hence access to the borrowing market to the Entrepreneurs who do not have a track record yet. Therefore, by the wealth commitment of the

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venture capitalist, firms could avoid the opportunity loss of foregone investments, if the bank refuses to finance.

Lam (1991) further states that the 'venture capitalist adds value through a reduction in the firm's credit risk'. This value added is translated into reduced interest costs and a larger line of credit. Similarly, if the credit account is maintained well further resources will follow at a reduced rate to finance growth as well.

The other areas of value addition include the venture capitalist serving as director, consultant, or strategic and tactical planner, sending assistance in recruitment or management and liaison with authorities as well as gaining credibility with suppliers and customers. This leads to incremental cash flows for the firm in terms of revenue or cost savings.

### **Time, Talent, and Treasure**

Innovative Entrepreneurs, as discussed earlier, in contrast to the ordinary firm Entrepreneur, 'are the ones who innovate and create new production possibilities, by altering the pattern of production or by uniquely coordinating the production factors'. However, there is a substantial amount of uncertainty about the success and consequently the wealth producing capacity of those endeavors. Here the venture capitalist steps into nurturing the venture. He provides Time, Talent, and Treasure (the three T's of venture finance) required by the Entrepreneur. (Raphel, 1990).

Interestingly, venture capitalist finds interest in taking up a majority stake in the assisted company and in continuing the association. The association is time bound and in the majority of cases, the venture capitalist will be happy with a lesser holding of equity than the Entrepreneur. Sometimes losing controlling interest of the firm would be a discouraging factor for the Entrepreneur to invite outside financiers through equity. Ibanez (1989) explains: "for his investment the investor would expect to receive a minority share holding in the company or the irrevocable right to acquire it." In

this regard the venture capitalist's attitude deserves appreciation.

From the angle of the venture capitalist, lack of a controlling stake along with unconditional extension of finance to yet-to-prove-success companies is a high-risk engagement. Moreover, constant monitoring of the assisted firm and extension of expertise in various fields by active involvement in strategic management by venture capitalists is also to be rewarded adequately. In this context, Harrison (1990) writes, "the relatively high risks for venture capitalists are compensated by the possibility of high returns usually through substantial capital gains in the medium term".

In today's market, venture capital essentially involves the financing of small and medium sized companies through the early stages of their development, until they are established and able to raise finance through the conventional industrial finance markets. The funding of such firms will require money for start up, for introduction of new products, and second round development capital for expansion.

### **Tech-friendly Finance**

Originally venture capital was seen as a virtual panacea to the "equity gap" prevailing in the classical industrial finance market due to the fact that the support of traditional financial institutions was predominantly based on the tangible assets the invested company holds. Moreover, established institutions have procedural and risk aversion biases and are geared towards highly collateralized lending procedures, rendering risk assessment under unconventional lending conditions virtually impossible. In fact, venture capitalist fills the gap in the equity capital scenario for small and medium sized enterprises. By changing venture capital into high tech fields, the "technology gap" which arose as a consequence of failing productive investment capital could also be filled (Harrison 1991).

A large number of empirical studies have revealed the role of venture capital in the formation

of Technology-based business in the USA, UK, Canada, Japan, and South Korea. Such businesses include, among others, semiconductors, personal computers, biotechnology, CAD-CAM, Software and artificial intelligence. Outstanding success stories in the USA include digital equipment corporation (DEC), Apple, Microsoft, Sun Microsystems, Intelligence, and Gene-tech. Recent years have witnessed an explosion in venture capital financing of high technology business in the USA. Indeed more than 85 percent of all venture capital has flowed into technology intensive areas (Florida 1988).

By supporting technology transformation, venture capital serves in large measure to formalize the roles historically played by the Entrepreneur and independent financier to the innovation process. In other words, venture capital has been the fuel for the Schumpeterian creative-destruction process of innovation. Schumpeter (1934) stated that, new combinations of the means of production and credit achieve the classic destruction of economic equilibrium by Entrepreneurs. He further observed that, it is not the price competition which counts, but the competition from the new commodities, the new technology and the new type of organization. The competition which commands a decisive cost of quality advantage and which strikes out at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives. In this context the venture capitalist disturbs the prevailing equilibrium by fostering the introduction of new goods, services, processes and markets.

The success of innovative enterprise was unpredictable due to the newness of products and processes. Similarly, the enterprises were often small in size and the majority of the Entrepreneurs

The majority of the Entrepreneurs belonged to the new generation and were technocrats. These made them unacceptable to the conventional financial market. However, the immense potential of these enterprises demand a supporting system. It is therefore vital to address certain infrastructural issues related to financing those enterprises.

belonged to the new generation and were technocrats. These made them unacceptable to the conventional financial market. However, the immense potential of these enterprises demand a supporting system. It is therefore vital to address certain infrastructural issues related to financing those enterprises. As the risks are very high, equity capital is preferred. Since the enterprises are new and owned by technocrats, it is also essential to provide management expertise. On analyzing the

characteristics of venture capital in detail, it was found to be capable of providing both equity capital and management expertise. Therefore, it is appropriate to setup venture finance organizations. Policy makers should encourage the formation of these organizations.

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