Guided Industrial Credit

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Abstract

Industrial credit providers in developing countries have been experiencing serious financial distress since the late 1970s due to persistent loan default and loan loss. Despite the application of a number of remedial measures, loan loss problem continued to haunt them. This paper argues that loan loss problem can be tackled by providing guided industrial credit which involves guiding the industrial entrepreneurs from the set up stage of the industrial firms to the liquidation of loans through all vicissitudes of their existence. If the industrial entrepreneurs who are mostly inexperienced are left unguided or unaccompanied, misuse and diversion of loans together with the existence of sick firms will become a prominent feature. Evidences collected from Oman and Bangladesh supported such contention. This suggests that unguided credit should be replaced by the guided credit for advancing industrialization in developing countries.

Key Words: Loan default, developing countries, and developmental role
1. Introduction:

Development finance institutions (DFIs) and commercial banks (CBs) providing industrial credit, henceforth together called industrial credit providers (ICPs), in developing countries are ravaged by persistent loan defaults and massive loan loss. This is evidenced by the under-capitalization and illiquidity of a large number of ICPs in developing countries. A study by the World Bank (1993) which provided credits to 160 DFIs (Bhatt 1993) reported that DFIs in 33 countries were in financial distress due to persistent loan default problems. An identical finding was reported by Calomiris and Himmelberg (1993). They found that the loan recovery rate which is the inverse of the default rate fluctuated between 30 to 40 percent throughout the developing world. From an individual country point of view, loan default rates have been recorded at 75 percent in Nigeria (Njoku and Obasi 1991), at 32 percent in Costa Rica (World Bank 1995), at 30 percent in Pakistan (Aleem 1990) and at around 95 percent in Bangladesh (World Bank 1996; and Hoque 1999). The existence of such disturbingly high rates of loan defaults has lead to the closure of a number of DFIs (Odedokun 1996; and Krahnen and Schmidt 1994) in developing countries.

According to the World Bank (1993) record, as many as 70 financial institutions had been liquidated in Argentina by 1983, by mid-1980, the net worth of the Ghanian banking system was negative and in the Philippines, 2 large public banks and 5 private banks were liquidated in 1996. Among those which are still in operation, many turned either into unprofitable financial organisations (Murinde 1996) or into financiers of moribund loan programs (Srinivasan 1994); some of them have become institutions resembling welfare agencies, instead of viable financial institutions (Hunte, 1992; and Hoque 1999).

This malaise in the development finance market has not only impaired the existence of many DFIs, but also adversely affected the economies of developing nations. Manufacturing industry growth objectives remained unrealized, national economic growth stalled, financial deepening in least developed areas slowed down and external debt-dependency has grown. Despite the application of a number of remedial measures, such as supplying fresh funds under bail-out programs, loan rescheduling, imposition of penal interest rates, denial of
additional credit to repeat defaulters, management take-over of problem projects, and legal actions, loan default problems continued to reign the credit markets in developing countries.

Available literature (Hoque 1999; Gupta 1990; and Sinkey and Greenwalt 1991) suggest that loan default occurs when borrowers are not able and/or willing to repay loans. There are borrowers who are willing but not able to repay loans and there are borrowers who are able but not willing to repay loans. Loan default occurs in either case. This paper advances this argument that unless the use of industrial credit is guided by the ICPs, loan default and loan loss will continue to haunt the financial institutions in developing countries.

This paper is divided into four sections. The first section presents introduction. Second section deals with the conceptual aspect of the GIC, while third section concentrates on theoretical consideration and hypotheses relating to the GIC and industrial loan default. In the fourth section, the hypotheses relating to the relationship between unguided credit and loan default were tested in the light of evidence gathered from Oman and Bangladesh. Summary and conclusion are provided in the final section.

2. Conceptual aspects of guided industrial credit

Guided industrial credit, henceforth called GIC, is like a guided missile. It is a special type of credit the use which should be guided by, like a guided missile, the ICPs from the set up stage of an industrial firm to the liquidation of loans. The GIC can be delivered only when ICP plays industrial developmental role which Gerschenkron (1966, p.14) defined as 'accompanying an enterprise from cradle to grave, from establishment to liquidation through all vicissitudes of its existence'. Kane (1975, p.15) also believes that industrial 'promotional function - identifying potential entrepreneurs, helping them to identify viable industrial projects, assisting them with back-up services during their early efforts - is also essential. Providing capital is only a part of it'. It indicates that the delivery of GIC by the ICPs, which is essentially a financial role, should be complemented by their developmental role. In fact, financial role and developmental role of the ICPs should be played in mutually reinforcing manner. Bhatt (1993) and Kitchen (1986) termed such dual roles of the ICPs as 'functional dualism', which they think is appropriate in a developing country.

The logic behind the involvement of the ICPs in terms of providing entrepreneurial guidance emanates from the fact that developing countries lack 'a substantial nucleus of entrepreneurs', (Ramirez 1986, p. 34) 'capable of
identifying, assembling, and financing sound industrial projects’ (Perera 1968, p. 200). Though the supply of entrepreneurial talent is abundant in developing countries (Nienhaus 1993), they are, by and large, inexperienced and budding or first generation entrepreneurs who, having trading or farming background, do not possess enough knowledge and skills regarding conception, execution and operation of viable or bankable industrial firms. In order to overcome such problem, available entrepreneurial talents should be harnessed and trained by the ICPs in various aspects of industrial firm management. However, before such training is provided, a skill survey should be conducted by the ICPs to determine training needs against existing and emerging requirement for entrepreneurial skills. Once training need is established, entrepreneurs should be inducted into the training programs in group setting. The established entrepreneurs should also be inducted into skill training program to make them competent to deal with the existing and emerging problems that may remain beyond their understanding and conception.

It is also imperative that the training departments of the ICPs should be staffed by the specialist staff who are competent to provide training, counseling and guidance to the entrepreneurs to improve their entrepreneurial qualities. These skill development training program should cover various aspects of an enterprise such as selection of viable or bankable firm, preparation of sound business plan and empowering firm personnel with specific authority and responsibility. In addition, issues relating to operational improvement, marketing strategies, costing, pricing, product-mix and financial management should be included in the training program. Buyer-meet, trade shows, export workshop and study tours to the successful firms can be included in entrepreneur training programs.

In a backward economy where some of the factors necessary for industrial development are not present or, if present, are not available in a form conducive to industrialization. That's why, paternalistic involvement of the ICPs in terms of providing guidance in all activities of the client-firm is desperately required, in addition to providing entrepreneurial skill development training. Kane (1975) identified capital, entrepreneurship, technical and managerial capabilities, promotional activity, capital market activity and availability of foreign exchange as the missing ingredients. This suggests that ICPs can further industrial development by supplying catalytic increments of these missing factors on their own initiative. Ligeti (1985, p.311) believes that it is the responsibility of the ICPs ‘to provide technical, professional, marketing etc. consultancy to the applicants of the credit’. It does not mean that the ICPs will not get directly involve in the functioning of the firm. They will only work as catalyst and facilitator. They will provide detailed counseling and catalytic intervention in a proactive
and supportive manner for improving the borrowers' ability to repay loans.

In order to play developmental role, the loan officials should sit on the board of the client-firm to monitor the performance of the client-firm. Since GIC serves as a deterrent against the misuse or diversion of loans, it is highly likely that loans will be used in the way it is ought to be used. Moreover, the firm can get a quick response from the ICP if anything goes wrong or stands on way of profitable operation. This suggests that GIC embodies a monitoring mechanism which serve as an important conduit for necessary technical and managerial advice, and financial accommodation for improving borrower's ability to repay loans.

Conventional industrial development finance institutions provide unguided industrial loans which are, in most of the cases, not accompanied by their developmental role. The problem with the unguided credit is that, it attracts unskilled and credit unworthy borrowers who do not disclose true information in most of the cases. Since the credit markets in developing countries are highly imperfect (Kane 1975), non-transparent and plagued by information asymmetry (Gopal 1993), borrowers can get away without revealing their true financial position. There is lack of effective mechanism to elicit information regarding actual financial position of the borrowers. The ICPs are cheated by the willful defaulters in such a market environment in the form of misuse and diversion of loans from the intended purpose for which loans were provided. The GIC along with the developmental role can insulate the ICPs against the fraudulent behavior of the borrowers which contributes towards improving loan repayment performances of the borrowers.

The ICPs in developing countries closely follow western banking system which is suitable for developed and transparent financial market. That is why, they concentrate only on financial role though they should play developmental role simultaneously. They perform industrial development function by playing financial role. It means that they perform a function for which they not well-equipped. It follows that unless they combine their financial role with their developmental role, as required under the GIC program, it is highly likely that the industrial loan default problem will continue to haunt the developing countries in future.

3. Theoretical considerations and hypotheses

The significance of the GIC for reducing industrial loan default in developing countries can be better understood by examining the relationship between unguided loans and industrial loan default. When the use of industrial
Credit is not preceded by entrepreneurial and management skill training and succeeded by ICP's catalytical intervention in loan administration process, the budding or first-generation entrepreneurs will not be able to execute industrial plans and operate them successfully to generate enough income to repay loans. This suggests that loan default is associated with the unguided industrial loans provided by the ICPs.

Credit unworthy borrowers can have access to the loan regime and decamp with the loans if the borrower's screening mechanism is intrinsically weak. Hunte (1992) found that inefficiency of borrower’s screening mechanism is positively related to the reign of information asymmetry. Banks do need accurate and reliable information to screen-out unworthy or bad borrowers from the pool of loan applicants. The borrowers know more about their financial condition, capacity to operate a firm and ability to repay loans than banks do. Even if banks endeavor, they cannot get all necessary information from the borrowers if there is no mechanism in place to share borrower's information among the lenders. By improving the efficiency of the borrower screening mechanism, information asymmetry and hence, loan default can be reduced to an appreciable level (Hoque 1999).

The GIC can be an effective tool to elicit pertinent information from the borrower by getting them involved in many aspects of the firm. One of them is asking the borrowers to lodge business plan along with the loan applications. The first-generation or budding entrepreneurs have limited knowledge regarding business plan and the ICPs will have to assist them in this regard. While working with them, bank officials can get an idea about the level of entrepreneur's knowledge and skills regarding various aspects of industrial investment such as construction work, machinery selection, production plan, estimated financial statements, logistics, and similar issues. This process will not only provide insight and useful information on honesty as well as competency (Koford and Tschoegl 1999) of the borrower, but also will reveal more information about the borrower's true intent or willingness and ability to repay loans. Since the credit unworthy borrowers will be reluctant to disclose pertinent information to the loan officials, they will be screened-out by themselves. This indicates that reduction of informational asymmetry and hence, loan default incidents is possible if GIC is provided by the ICPs.

Under current system, the ICPs consider reputation and relationship of the borrower and collateral (Koford and Tschoegl 1999) before loans are sanctioned. Reputation is related to repeat borrowing in the sense that if the borrowers default, they will not be able to borrow again from the same lender. If borrowers can keep the lender ignorant of their previous borrowings from the other lender, loss of reputation will not pose a problem to avail fresh loan from this lender. But this is not possible under GIC program which requires both the lenders and
borrowers to agree to apply for fresh loans. If such loans are provided by the ICP itself, use of the reputation of the borrowers as default-deterrent will become unnecessary.

Usually, lenders take collateral as security against loan loss. When a loan goes bad, the lender's first line of defense is to seize and sell the collateral. If the borrowers are able to overstate the price of the collateralized assets, it is highly likely that the lender will get lower value of the collateral than their stated value. This suggests that collateral alone does not guarantee the protection of the lender against loan loss. If the overstated value of the collateral increases the benefits of loan default more than the cost of not repaying the loans, the borrowers will have an incentive to ignore loan repayment obligation. This serves as recipe for the growth of defaulted loan amount. GIC can serve as a deterrent to such practice of the borrowers by determining the real value of collateral. As banks will be involved in determining pricing, selection, procurement, assembling, installation and operation of machinery as well as construction of physical structures such as firm building, overstating the value of these fixed assets which are used as collateral will not be as easy as with the unguided industrial credit. Thus, GIC will provide better protection against the risk of loan loss than those provided by the unguided industrial credit.

When the use of credit remains unguided, it provides ample opportunities to the borrowers for overstating the construction cost of the firm and over-invoicing of the imported machinery. By resorting to such practice, borrowers can divert a large chunk of loan from firm's account to their private account. As a result, the firm will either remain unimplemented or implemented with inappropriate machinery and low quality construction work which makes the firm sick or inoperable. More disaster follows when lender takes these fixed assets as collateral. As the ICPs will not be able to sell the defective machinery or physical structure and hence, loans will remain unrecovered. By supplying GIC, the ICPs can close the loopholes that provide incentives for over-invoicing and overstating the values of fixed assets by deploying its officials at each stage of machinery selection, procurement and installation, and construction of physical structures. This will ensure not only the implementation and operation of the firm within set time, but also protect the true and full value of the collateral. These suggest that unguided credit ends up with more sick firms than do by the guided credit.

Under unguided industrial credit program, the fixed asset to working capital loan ratio (i.e., long term loans to short-term loans) and debt to equity ratio are always high as borrowers want to acquire more fixed assets which provide more opportunity for loan diversion. But the scope for over-invoicing of fixed assets are limited under GIC program and more fixed assets become less attractive to the borrowers which results in lower debt-equity ratio. Sinkey and Greenwalt (1991) found that the higher ratio of loan to assets, higher ratio of debt-equity and
low equity-to-asset ratio are associated with the higher risk of loan default. Under GIC program, as more fixed asset loans becomes unnecessary, lower debt-equity ratio will be the main feature of firm's capital structure which will reduce the chances of loan default. As the firm's debt-equity ratio will be low under the GIC program, there is likelihood that firm will not suffer from the dearth of working capital unlike the firm having unguided credit. The flow of necessary working capital loan will support continuous business operation. With better cash flow, firm having GIC will be more able to repay loans than firms having unguided credit.

The ICPs resort to court cases to recover loans from the debt-defaulters. Koford and Tschoegl (1999) found that courts were slow and inefficient in respect of recovering loans from the defaulters. Moreover, recovering loans through legal action is not cost-effective. There are explicit cost such as legal and court fees and implicit cost such as cost of managing insolvent firm which is taken over through legal action. These can be avoided by providing GIC which requires that the loan officials of the ICPs should sit on the firm's board of directors. By taking such position, they can monitor firm's activities like "a kindly old physician monitoring the behavior of his patients" (Borts 1977, p 10); and can advise the firm to take proactive or reactive measures to deal with the existing as well as emerging problems. For instance, when the ICP detects that a firm has been suffering from illiquidity, it can inject working capital to preempt the problem of insolvency of the firm. These measures can improve borrower's ability to repay loans to a large extent. This will reduce the involvement of the ICPs in lodging court cases against the loan defaulters. It is highly likely that ICPs providing the GIC will lodge less legal cases than their counterparts providing unguided credit.

The ICPs provide credit to intrinsically risky firms and in order to minimize the risk they charge high interest which attracts bad borrowers (Stiglitz and Weiss 1981). The borrower's willingness to accept high interest rate itself signals adverse selection of borrowers. When the borrowers default in repaying loans, the ICPs impose penal interest on the defaulted amount which again increases debt-default and the cycle continues. Thus, debt burden may grow beyond the net worth of the firm. Hoque (1999) found that high interest rate was a potential cause of loan default in Bangladesh. As the risk of loan loss is lower with the GIC, the ICPs can charge relatively low interest rate which will reduce the risk of loan default. This suggests that the probability of loan loss is far greater with unguided credit than with GIC.
4. Evidences from Oman and Bangladesh.

The contribution of the GIC towards reducing industrial loan default has been examined in the light of the experiences the ICPs had in Oman and Bangladesh. Take first the case of Oman. Industrialization in Oman got momentum from early 1980s and most of the industrial finance were provided by the Ministry of Commerce and Industry (MCI) through Oman Development Bank (ODB) and commercial banks (CBs). In fact, these lenders are the main ICPs in Oman though there is one specialized financial institution called Industrial Development Bank of Oman which is now in embryonic stage. The case is different in Bangladesh where two state-owned industrial development finance institutions (DFIs), namely, Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sangstha (BSRS) have been providing long-term loans to the industrial entrepreneurs since early 1970s. In addition, four nationalized CBs have been providing term loans to the entrepreneurs since the late 1980s. However, industrial DFIs and CBs are the dominant ICPs in Bangladesh.

The industrial finance markets in Oman and Bangladesh have some common features. Despite wide variations in respect of roles, nature of business and operations, the ICPs in these countries were savaged by persistent loan default and loan loss. Until June 2002, Bangladeshi industrial borrowers owed Taka 23.390 billion (US$ 400 million) to the industrial DFIs and commercial banks (Bangladesh Bank 2002). On the other hand, the Omani borrowers owed RO 39 million (US$ 101 million) to the CBs and MCIs until June 1999 (Central Bank of Oman 1999 and MCI 2001). Market imperfections, distortions and inefficiencies and information asymmetry reign the financial markets in these countries. Most of the industrial finance came from public ICPs and the majority of the industrial entrepreneurs had farming or trading background and are the first-generation or budding entrepreneurs. None of the ICPs in these countries provided GIC and all of the loans were unguided, though loans in Bangladesh were better supervised compared to Oman.

This study focused on the loan cases of the MCI in Oman and BSB in Bangladesh as test cases. Both these organizations are the largest IPCs in these countries. Data were collected from primary and secondary sources, and instruments used were structured questionnaires, firm and borrower visit and interviews. It is to mentioned here that adequate data from the Omani firms could not be collected due to the non-cooperation of the expatriate CEOs and the Omani entrepreneurs who do not play active role. Consequently, some of the hypotheses could not be tested in Oman. The study elicited pertinent information from 54 firms financed by the BSB and from 27 firms financed by the MCI under Government Shoft Loan (GSL) program. As of June 1999, borrowers owed Taka 15.5 billion (US$ 267 million) to the BSB which collected only 10.52% of total loan outstanding. Oman
has also identical experience. Among the 27 firm financed by the MCI, all but one firm have failed to repay loans and total dues from them stood at RO 2.16 million (US $ 5.61 million) as of December 2000. Among the 54 Bangladeshi firms, one third were sick (meaning a firm left unimplemented or about to be abandoned) and the corresponding figure for Oman was nine-tenths (24 out of 27). About 69% of the Omani firm-owners were first-generation entrepreneurs and their Bangladeshi counterpart owned 54% of the firms under study. None of these entrepreneurs has got any previous industrial experience or skills and none was trained or guided by the lenders either in Oman or Bangladesh. Being left unguided, they were not able to put the firm in operable conditions. This made them unable to repay loans.

The Omani entrepreneurs are, by and large, sleeping or passive owners who play only the investor's role. They have left most of the affairs of the enterprise to the expatriate CEO who lacked authority to take important decisions as and when needed. Take the case of an Omani entrepreneurs who recruited a CEO to his security equipment manufacturing firm. The expatriate executive lacked commercial skills and leadership quality to initiate and implement requisite changes which have left the firm in the doldrums for years. Had the entrepreneur intervened in time, this firm could have been saved from becoming a sick firm. The situation was relatively better in Bangladesh where the entrepreneurs were investors as well as promoter.

The borrowers' screening mechanism employed by the ICPs in Oman and Bangladesh were weak and inefficient which allowed credit unworthy borrowers to have easy access to the long term credit regime. This is evidenced by the existence of large number of sick firms owned by the credit unworthy borrowers. Had the screening mechanism was efficient, experienced and credit worthy borrowers could have been selected and firms would been implemented and few firms would have been sick. It has been disclosed by the 69% of the Omani borrowers and 39% of the Bangladeshi borrowers that they were attracted by the favorable terms and conditions of the ICPs. Had there were stringent conditions and stricter compliance of the loan conditions, these entrepreneurs would not have applied for loans. This support the hypothesis that the GIC provides the better mechanism for selecting good borrowers than unguided loans.

It appears that the Omani and Bangladeshi industrial entrepreneurs took the advantage of information asymmetry that griped the respective industrial credit market. The industrial borrowers availed loans from several banks by providing same asset as collateral. As there was no loan register (which was supposed to be maintained by a central authority) to record information regarding the assets to be collateralized, loan sanction, loan disbursement and loan repayment, ICPs could not verify the true status of the collateral, previous loan liability
and repayment performance of the borrowers. In fact, the true value of these assets, which were taken by the ICPs as collateral, was far less than book value and as a result ICPs could not even recover a fraction of the defaulted loan amount by selling these under-valued assets. As neither Oman nor Bangladesh had any collateral register at national level to record on collateral, borrowers were able to unsmart the lenders in terms of providing same collateral against several loans from different lenders. Even one lender mentioned to the author about the disappearance of collateral from the warehouse. The undervalued collateral was provided just to divert loan money to support conspicuous consumption spending. This was acknowledged by the Central Bank of Oman when it predicted that "...a certain degree of diversification is to be expected between purpose for which credit is sanctioned…and the purpose to which it is actually allowed" (Annual Report 1999, p. 65). Sobhan (1991) reported that the practice of over-invoicing of imported machine was widespread among the Bangladeshi entrepreneurs who transferred much of the unguided loan money from the firm account to their personal account. Had the use of loans was guided by the ICPs, the borrowers would not have been able to divert the loans from their intended purpose. This supports the hypothesis that higher loan default is associated with the unguided loans than with the GIC.

Against the required involvement of the ICPs in terms of providing entrepreneurial guidance at the pre-credit approval stage, it was found that no ICP either in Oman or in Bangladesh has ever provided any technical, financial or promotional skill training to the industrial entrepreneurs before loans are sanctioned and/or disbursed. None of them demanded any business plan from the entrepreneurs before loans were sanctioned or disbursed. As regards the assistance to the entrepreneurs at the implementation stage, the involvement of the BSB was relatively better than its Omani counterpart. This Bangladeshi lender provided advice to the 23% firms regarding building construction. However, 37% firms received suggestions regarding machinery installation. Less than half of the firms surveyed received follow-up visit from the BSB which indicated that the majority of its client-firms were left unassisted at the implementation stage. The lack of such assistance have contributed towards the sickness of 24 firms (out of 27 firms studied) in Oman. The corresponding figure for the BSB was one third of the total firms surveyed. Even when firms remained unimplemented, ICPs haunted the borrowers for recovering loans.

None of the Omani and Bangladeshi ICPs provided any advice to the firms at their operational stage. The untrained and unskilled entrepreneurs were to rely on their limited knowledge and hired personnel for important aspects of enterprise management such as inventory management, product-mix strategy, marketing and sales
plan and incentives, and financial management. Most of the firms in either country did not received necessary working capital from the ICPs and this was corroborated by 84% of the firms financed by the BSB. Being starved of working capital, these firms could not utilize production capacity to generate enough cash flow to service the debt.

Though monitoring is an essential part of the GIC, it did not receive adequate attention from the ICPs to deal with the existing and emerging problems of the client-firms. Though the BSB placed its officials on the board of the firms, only 25% of the board meetings were attended by them and majority of them were generalist, not specialist. As per conditions of loans provided by the BSB, the client-firms were required to lodge quarterly operational data and financial statements. But only 10% firms complied with such loan conditions as there was no penalty for non-compliance. As a result, firms were deprived of necessary advice before it was too late. All these lapses were due to the fact that credit they provided were largely unguided.

5. Summary and conclusions

The industrial credit providers (ICPs) in developing countries such as Oman and Bangladesh have been ravaged by persistence loan default and loan loss since late 1970s. Despite the application of a number of remedial measures, debt-default and loan loss continued to haunt the ICPs. This paper advanced the thesis that given the fact that industrial sector in developing countries is infested mostly by the budding or first-generation industrial entrepreneurs having farming or trading background and that non-transparent financial transactions, imperfection and information asymmetry reign the financial markets, the ICPs should provide guided industrial credit (GIC) which involves guiding the industrial entrepreneurs from the set up stage of the industrial firms to the liquidation of loans through all vicissitudes of their existence. If these entrepreneurs are left unguided or unaccompanied, misuse or diversion of loans from the pool of the investment together with the existence of sick firms will become a prominent feature. Unless the ICPs show paternalistic involvement in all activities of the client-enterprise, it would be unrealistic to expect that the GIC will make the budding entrepreneurs financially able to repay loans. The evidence collected from Oman and Bangladesh supported the main hypothesis that unguided credit was the prominent cause for borrowers’ inability and unwillingness to repay loans which caused loan loss. This suggests that GIC should constitute an effective instrument of the credit policy of the ICPs in order to
reduce persistent loan loss in developing countries such as Oman and Bangladesh.

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