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Approach

This study analyzes the constraints faced by small farmers in Colombia in accessing formal credit. Through a literature review and an empirical analysis, it identifies frictions that constrain small farmers' access to credit by increasing costs for financial intermediaries or discouraging producers from applying for financing.

The analysis begins with a characterization of the agricultural credit market in Colombia and the institutional framework that regulates it. It examines current financing mechanisms, paying special attention to the Agricultural Bank of Colombia (BAC) and the Agricultural Guarantee Fund (FAG). Then, it presents empirical studies that seek evidence of market frictions and evaluate the impact of certain policies on credit access for small farmers in the country.

Contribution

Provides evidence of constraints that hinder small farmers' access to credit in Colombia, estimates the effects of some policies to mitigate these constraints, and proposes policy recommendations.

> **"Although these frictions affect various credit markets, they are especially relevant in rural areas of developing countries due to transportation difficulties and lack of formal documentation."**

Results

Despite recent improvements in coverage, small producers' access to credit remains heavily dependent on the BAC and FAG backing. Also, the study finds evidence of frictions creating constraints to credit access for these farmers. These frictions include:

Transaction costs: with a significant component of fixed costs in credit placement. These costs are associated with finding clients, collecting documents, and evaluating borrowers, among others. As these are costs incurred by intermediaries regardless of the credit amount, they particularly increase the cost of credit placements to small producers, who generally demand smaller amounts. Additionally, transportation difficulties to rural areas and the wide geographical dispersion of producers increase these costs.

Information asymmetries: arise because borrowers have better information about their risk profile and actions to repay debts than lenders. This increases default rates and, consequently, the costs of providing credit, which reduces supply.

Risk exposure: climate risk is an important source of uncertainty in agricultural production. We find evidence that this risk reduces small farmers' access to credit and their ability to use credit as an income smoothing mechanism after negative shocks.

Although these frictions affect various credit markets, they are especially relevant in rural areas of developing countries due to transportation difficulties and lack of formal documentation.

The analysis also suggests that the most effective policies for improving credit access are those that mitigate frictions. For example, we find that the FAG mitigates costs associated with risk and information asymmetries, allowing lower interest rates and, consequently, lower delinquency. However, its sustainability should be evaluated based on its cost, and alternative mechanisms, such as backing through commercial partners, could fulfill a similar function at a lower cost.

Finally, we find that interest rate caps on development loans can restrict the supply of this type of credit by making it difficult to recover placement costs. A review of these caps should consider the risk and cost of loans.