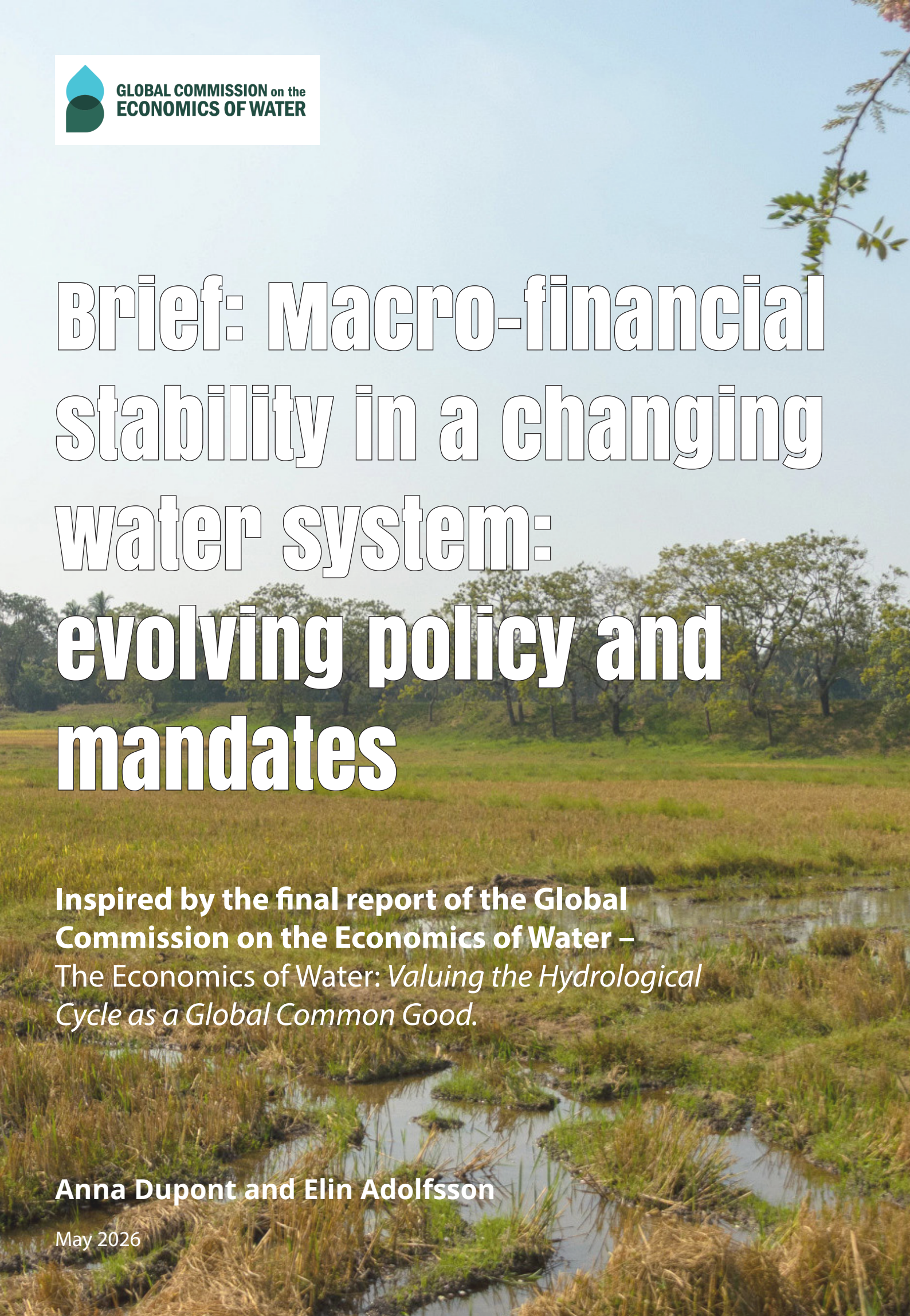

GLOBAL COMMISSION on the ECONOMICS OF WATER

Brief: Macro-financial stability in a changing water system: evolving policy and mandates

Inspired by the final report of the Global Commission on the Economics of Water – The Economics of Water: *Valuing the Hydrological Cycle as a Global Common Good.*

Anna Dupont and Elin Adolfsson

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The Global Commission's report sets out the shifts required to drive radical change in how water is valued, managed, and used.

Human activity is destabilizing the water cycle, turning hydrological disruption into a systemic macro-financial risk: not only through scarcity, but through persistent spatial and temporal mismatches between water availability and economic activity that erode growth, fiscal capacity, and trade stability. Macro-financial frameworks underestimate these risks by overlooking green-water systems, storage dynamics, and interconnections; as ecohydrological buffers degrade, economies enter a "long emergency" in which weakening natural systems quietly undermine debt sustainability, inflation control, and investor confidence, while amplifying inequality and eroding resilience.

This brief argues that the structural reshaping of the water cycle now demands a re-specification of macro-fiscal diagnostics, debt-sustainability assessments, and international financial instruments (including the International Monetary Fund's Resilience and Sustainability Facility) around hydrological integrity itself, treating eco-hydrological systems as core productive and protective capital rather than a peripheral environmental concern. Placing water-cycle stability at the core of macro-financial governance and aligning finance with the regenerative limits of water systems is essential for resilient and inclusive growth.

This brief is the first of two examining the water cycle and finance. The second brief focuses on redirecting investment toward the water cycle.

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Key messages

- **Human activity is altering the distribution of water supply, turning hydrological change from a sectoral management concern into a structural macroeconomic shock.** Instability stems less from scarcity than from persistent spatial and temporal mismatches between rainfall, water storage, and economic activity, creating a structural drag on growth and fiscal capacity, especially in rain-dependent economies and "water-frontier" export models.

- **Agricultural production and trade align with water depletion, pollution, and deforestation.** Risks emerge where production, resource extraction, and land expansion exceed levels at which blue and green water would generate higher value by sustaining other ecosystems.

- **Macro-financial and climate models underestimate risk by neglecting storage trends, green-water dependencies, and misalignment between rainfall, resources, and economic activity.** Grounded in historical assumptions of stable water supply, they obscure the implications of shifts in total water storage for long-term stability.

- **Repeated water shocks and degraded ecohydrological infrastructure tighten fiscal space, accelerate debt accumulation, and reshape Debt Sustainability Analyses.**

- **Ecohydrological systems function as both protective capital that buffers shocks and preserves fiscal space, and *producing capital* that sustains long-term productivity.** Stability is therefore best understood as the ability to maintain growth, inflation, and debt on sustainable paths without depleting hydrological capital.

- **Recognizing hydrological integrity as macro-capital and a source of systemic risk demands that international financial institutions, central banks, and supervisors expand their understanding of stability and solvency.** It is urgent to build capacity to see the full water signal, upgrade models and data infrastructure, and accelerate supervisory innovation and the integration of water risks into core decision-making.

(*photo*: David Clode/Unsplash)

Context

Human land-use and climate change are transforming Earth's water cycle, the biosphere's circulatory system.

Water-related extremes are becoming more frequent, intense, and persistent, while degraded soils, pollution, depleted aquifers, and aging built infrastructure create lasting "headwinds" that reduce output and fiscal resilience long after droughts or floods have passed [1]. Water scarcity is spreading, and irrigation is increasingly sustained at the expense of environmental flows. Our economic and social models, which depend on the stability of the water cycle, are under increasing stress.

These pressures intersect with equity. Altered precipitation and drought patterns erode freshwater storage and the hydrological functions that sustain agriculture, biodiversity, and livelihoods for much of the world's poorest population (and incidentally, the largest terrestrial carbon stores). By 2050, water-cycle disruptions could cut average Gross Domestic Product (GDP) by 8% in high-income countries and up to 15% in lower-income countries as deteriorating water systems constrain production, investment, and labor productivity [2]. Water degradation is thus both a macro-financial risk and a distributional fault line, with vulnerability shaping how disruptions translate into growth, fiscal stability, and resilience.

While price stability and sound financial systems have long served as anchors of resilience, preserving them now depends less on managing isolated water shocks than navigating structurally growing water imbalances.

This brief argues that any serious normative shift, new generation of instruments, or even the sequencing of incremental reforms will have to be recast around a tilted water cycle to contribute, rather than quietly erode, macro-stability. Emerging guidance from international financial institutions suggests that economic authorities are shifting from a predominantly supervisory focus to a macro-fiscal lens.

Key challenges and implications

Exposure and structural mismatches: growth on the brink of an accelerating cycle

What appears as local water shocks are manifestations of a single, interconnected global hydrological cycle. The new normal is a global hydrological regime in transition, where tilted green[1] trends translate into macroeconomic vulnerability.

Yet, policy and financial analysis still interpret water risk through narrow "drought" or "flood" lenses, treating disruptions as shocks rather than symptoms of structural shifts. This obscures the signal: changes in terrestrial storage, basin thresholds, and ecosystem integrity are reshaping the foundations of growth, trade, and debt dynamics.

Specifically, instability arises less from absolute scarcity than from deepening spatial and temporal mismatches in availability. These imbalances systematically concentrate risk in rainfed systems and overdrawn irrigated lands, embedding distributional asymmetries into growth trajectories. Over time, these discrepancies become a structural drag on output and fiscal capacity, particularly in debt-ridden economies with constrained fiscal space. Concerns about "water bankruptcy" capture this pattern: the combination of structural overdraw of hydrological capital and rising financial indebtedness, in the absence of hydrological accounting, is not a sectoral anomaly but a macro-critical risk [3].

Prevailing production models reinforce these mismatches. Water-frontier commodities mirror forest-frontier dynamics where competitiveness is tied to natural capital depletion, privileging short-term gains at the expense of long-term productivity.

[1] "Blue water" refers to surface water and groundwater in rivers, lakes, and aquifers. "Green water" is water stored as soil moisture and in vegetation, returned to the atmosphere through evaporation and transpiration, generating around half of all rainfall over land.

Empirical evidence shows structural exposures already embedded in the global economy. A significant share of water-intensive agricultural production is concentrated in basins experiencing faltering green-water systems, undermining productivity and growth [4]. Simultaneously, 18% of global crop production and 30% of exports rely on forest-driven moisture recycling, largely from upwind ecosystems under pressure from deforestation [5]. This exposes supply, trade flows, and public revenues to degradation from distant hydrological systems, with acute impacts on poorer, rain-dependent populations.

Global trade further amplifies risks by embedding large volumes of green and blue water in a limited number of crops, regions, and firms. In Brazil, a few firms dominate virtual water flows in soybeans, handling around 100 billion m^3 (see Figure 1). A substantial share of global exports originates from "breadbasket" regions facing rising drought risk, declining storage, and deforestation-driven rainfall disruption, concentrating exposure in increasingly vulnerable systems [6]. Water-frontier export models constitute a distinct macro-financial risk class: they embed structural exposure to degrading hydrological systems, transmit water-cycle disruptions to trade balances and price stability, and lock in production patterns (increasing future adjustment costs [7]).

As hydrological buffers weaken and thresholds are crossed, structural mismatches translate into non-linear macro-financial risks: food price spikes, supply disruptions, inflation, and balance-of-payments pressures. Macro-financial analysis, assuming continued growth while treating accelerating changes in the water cycle and ecosystem degradation as marginal, is therefore misleading.

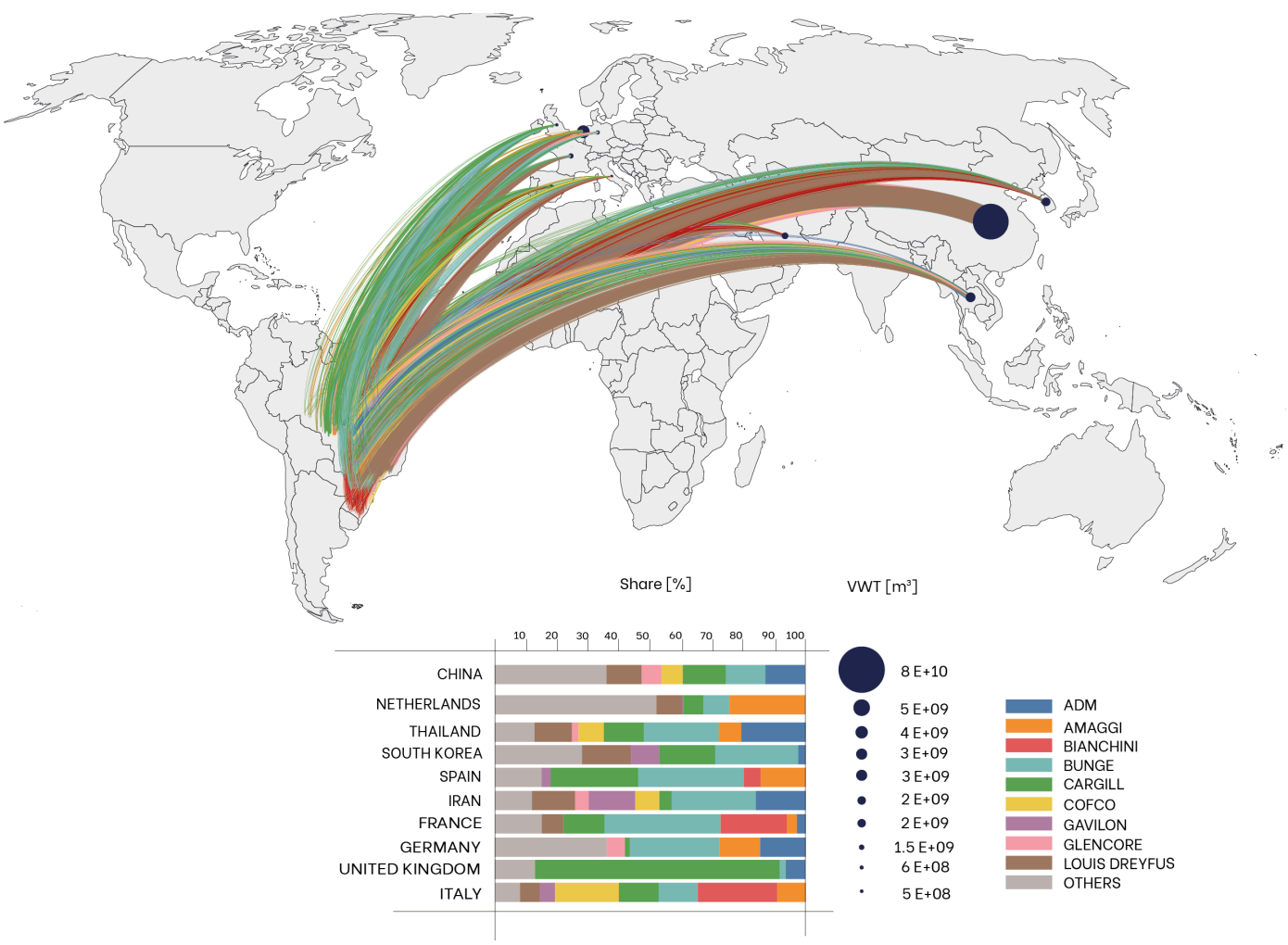

Figure 1. Virtual water flows linking local soy production sites in Brazil with traders and importers. Source: De Petrillo, E., Tuninetti, M., Ridolfi, L. Commun Earth Environ 4, 87 (2023).

Note: Virtual water (VW) flows depart from 1620 traced communities in Brazil and reach the top 10 importing countries. 4429 VW flows connect producing municipalities to the importers, though 9 dominant transnational corporations (TNCs). In 2028, these top TNCs handled around 100 billion m^3 of VW, about 70% of the total, corresponding to an average of 7 million m^3 virtually departing from each municipality.

Instrument gap and hydrological misspecification

The transmission of the changing water cycle through food, energy, and infrastructure into growth, inflation, fiscal space, and sovereign and banking-sector risk is no longer speculative but an observed reality [8].

Still, macro-financial tools reflect only a partial, climate-centric understanding of (cascading) physical risk that fails to capture the systemic properties of the water cycle. This creates a measurement gap: water services and events are tracked, but water-cycle metrics are seldom incorporated into macro-fiscal and prudential decision-making, especially for green-water systems, despite recent methodological advances.

The International Monetary Fund's (IMF) macro-criticality work maps key channels through which scarcity and recurrent droughts or floods affect growth, fiscal balances, and external accounts, and identifies investment needs for sustainable development across the "water value chain". Yet major dimensions remain largely untouched, including:

- Green-water and moisture-recycling dynamics,
- Cross-border basin linkages and teleconnections,
- Interactions between water, trade, and balance-of-payments risk,
- Transmission through financial markets and asset valuations.

Meanwhile, Organisation for Economic Co-operation and Development (OECD) analysis pointing toward embedding water risks in fiscal and prudential frameworks and treating them as macro-relevant offers a useful conceptual template [9]. This is important, but focus remains on shocks rather than structural hydrological change.

Extending current practice to align fiscal, debt, and prudential instruments with the realities of a more volatile water regime is therefore urgent.

The long emergency and the (structural) investment gap

Growth, inflation control, and debt sustainability increasingly depend on whether economies can function under multiyear hydrological stress, rather than their ability to ride out isolated shocks. This is particularly critical for economies and livelihoods that are highly dependent on blue and green water systems, where limited adaptive capacity amplifies impacts on already vulnerable geographies and populations. The gradual but cumulative weakening of the very systems keeping economies productive, prices stable, and communities secure constitutes a "long emergency". In macro-financial terms, an erosion of real collateral: ecohydrological capital.

Despite their role as a first line of defense for fiscal space (the healthier they are, the less severely budgets are hit by water-related shocks) and in backstopping debt metrics and investor confidence, ecohydrological systems barely register on the balance sheet.

African Development Bank President Akinwumi Adesina's insistence that Africa's savannahs, rainforests, rivers, and oceans, assets he values at least USD 6.8 trillion, should count as economic capital in national accounts exposes this quiet paradox [10]. African economies' real collateral remains largely off the books, while the costs of running it down are fully on the books in terms of weaker growth.

As long as ecohydrological assets remain outside the working definition of macroeconomic stability and capital, financial architectures will continue to underinvest and misprice risk. Closing the financing gap requires expanding what counts as macro-relevant capital and adjusting mandates and tools, particularly in how fiscal, debt, and financial-stability frameworks value and protect the water systems that economies depend on.

The stability of the water cycle is a distinct asset base. Maintaining the global water cycle within safe and just Earth-system boundaries,[2] as part of a broader safe and just corridor for people and planet, has become a precondition for macro-financial stability and integral to any financial-stability mandate. This sets the context for a different kind of policy response.

[2] The range of hydrological conditions that stabilise the Earth system and meet minimum human needs.

Policy pathways

Water cycles' integrity as a strategic anchor for stability

The first pathway is conceptual: ecohydrological infrastructure (underpinning water cycle integrity) must be recognized as both protective capital (assets that absorb shocks and preserve fiscal space) and producing capital (assets that sustain long-run productivity). For economic authorities, this means broadening the definition of stability to include biophysical conditions. In this framing, stability is best understood as the capacity to keep growth, inflation, and debt on sustainable paths without liquidating the hydrological capital that underpins production, exports, and fiscal revenues.

For example, in countries such as Côte d'Ivoire, where rainfed cocoa is almost entirely exported, export earnings, rural livelihoods, and fiscal space are effectively collateralized by local green-water dynamics. As with coffee, rising production losses linked to climate shocks, deforestation, and land-use change mean that this export-dependent model is increasingly exposed to the degradation of ecohydrological buffers. As deforestation, disruptions to moisture recycling, and land conversion are major drivers of green-water degradation, comprehensive macro-financial assessments must account for these dynamics. Similarly, macroeconomic assessments need to be updated for a world where rainfall shocks are the new normal and large swathes of land can be flooded.

This reframing (see Figure 2) requires different diagnostic questions. First, whether fiscal buffers, contingency mechanisms, and sectoral structures can cope with prolonged droughts or floods and slowly intensifying hydrological stress. Second, which irrigation-dependent or rainfed export sectors, regions, and employment bases are most exposed to changing rainfall, storage, and water quality, and whether diversification and just-transition strategies are in place to reduce systemic vulnerabilities rather than deepen them. Third, how far existing monetary and financial stability tools depend on assumptions of hydrological stability that no longer hold.

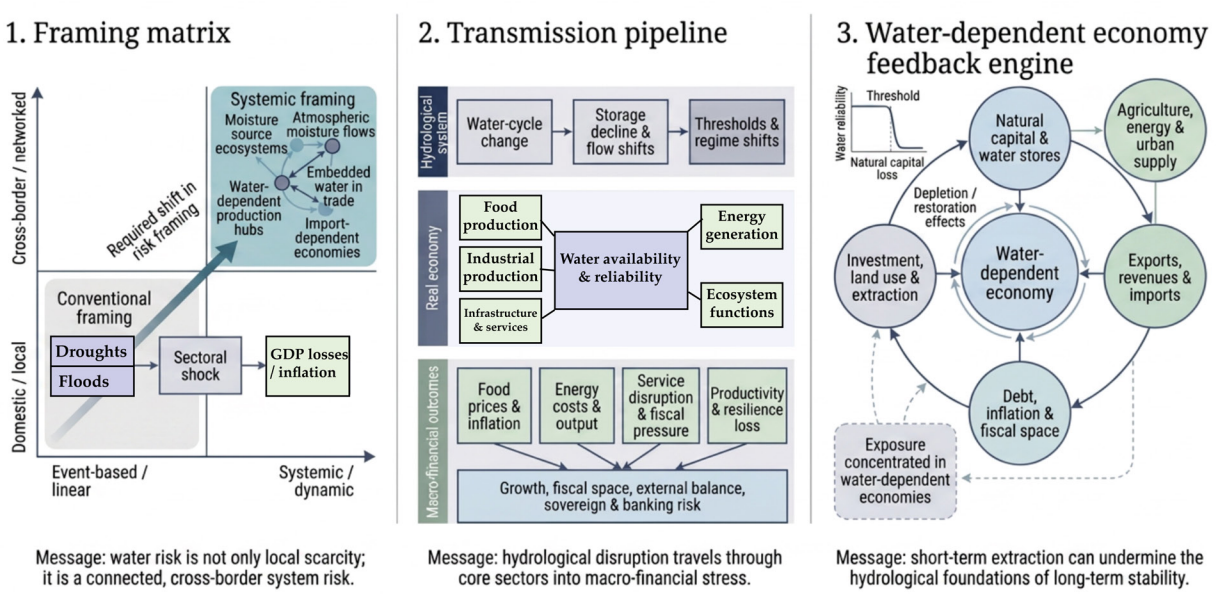

Figure 2. Water risks reframed from a local, (extreme) event-based problem to a systemic, planetary risk embedded in moisture flows, trade, and water dependent economies.

Bringing the water cycle into the macro-financial rulebook

The second pathway is architectural and instrumental: integrate water risk into macro-fiscal and financial-stability frameworks to steer capital toward ecohydrological assets.

From regional to global levels, the test is whether renewed norms, metrics, and incentives keep growth and financial conditions within the (regenerative) limits of water cycles. Although assessing water-related financial risks remains more complex than for climate due to fragmented data [11] and governance, waiting is not an option: immediate institutionalization of science-based tools can already yield more resilient water systems, production models, and economies.

Medium-term fiscal frameworks and debt-sustainability analyses increasingly integrate climate risks; the next frontier is hydrological disruption. This means considering ecohydrological systems, such as wetlands, forests, and soils, as systemic protection for economies and finance, and integrating hydrological degradation and sectoral water dependence into scenarios, stress tests, debt anchors, and indicative fiscal paths.

This would reveal where growth relies on depleting productive and protective capital, and where partnership-based finance and adjustment programs can be linked to plans to stabilize the water-economy system.

Prudential standards and surveillance practices set by international bodies can treat hydrological integrity as a first-order variable in financial stability frameworks, especially in low-income economies. Building on early severe drought scenarios and sectoral case studies developed under OECD guidance and related initiatives (e.g., NGFS climate-related scenario analysis and stress testing [12]; FSB climate risk work program 2026 [13]; ECB "Nature at Risk" [14]), authorities can progressively incorporate basin stress, storage loss, and sectoral water dependence into their scenarios and stress testing frameworks.

As the IMF began to use concepts close to planetary boundaries in analytic tools [15], this opens a pathway toward operationalizing hydrological stability and broader Earth system limits. This means water and nature are not just considered risks but binding constraints shaping programs, conditionality, and macro-fiscal rules.

Steering economies back within hydrological limits: a new generation of financial oversight

As debt pressures mount, the urgency of financing adaptive measures and inclusive growth is colliding with shrinking fiscal space. This configuration ties employment, exports, and fiscal revenues in many lower-middle-income economies to already-degrading hydrological systems, eroding the very adaptive capacity needed to cope.

Fiscal and macroeconomic strategies, therefore, need to be redesigned around resilience in water dependent jobs, exports, and public revenues. New key questions for decision-makers include which growth and debt paths remain credible when economies are tightly coupled to structurally changing water systems; the condition of the remaining ecohydrological infrastructure; and what "resilience critical" investment is needed to sustain it. The answers shape both consolidation and adaptive equity strategies, particularly where hydrological volatility amplifies inequality and debt stress by hitting water dependent regions, low income workers, and informal producers the hardest.

Global modeling suggests that countries can reduce macro-level water risks by directing scarce water toward higher-value activities, expanding less water-intensive sectors, and importing some of the most water-intensive goods. Doing so requires deliberate reforms in water pricing and subsidies, as well as tariff, trade, and land-use policies that conserve green-water systems and reshape where water-intensive production takes place, embedding water- and land-efficiency standards in trade flows [16].

Facilities such as the Resilience and Sustainability Facility and other climate-linked mechanisms can convert parts of short-term debt service into long-term investment in water security and ecosystem restoration, anchor fiscal reforms in water-system stewardship, and support diversification away from the most water-vulnerable sectors. In practice, this means treating investments in ecohydrological infrastructure as core components of fiscal stability, tying part of debt relief and concessional finance to measurable improvements in green-water systems and livelihoods.

Recommendations - who moves what to build systemic water resilience

It is pivotal to anchor seeds of long-term resilience across the system by setting a clear direction of travel and redirecting finance towards systemic interventions, and by aligning mandates, tools, investment decisions, and production models with hydrological integrity. Delivering this agenda depends on multiple streams of agency converging.

Ministries of Finance

- Embed water resilience in fiscal and debt frameworks: integrate water related risks and ecohydrological infrastructure into medium-term fiscal frameworks, debt sustainability analyses, macro-fiscal scenarios, and the calibration of debt anchors and consolidation paths, so adjustment strategies safeguard water dependent jobs, exports, and tax bases.
- Reform water pricing, subsidies, trade, and land use policies to steer scarce water toward higher value while cushioning vulnerable regions, workers, and producers from hydrological shocks and food price spikes.
- Leverage climate linked debt instruments for water resilience: convert part of short term debt service into long-term investment in water security and ecosystem restoration, tied to credible water cycle stabilization plans.

Central banks and financial supervisors

- Set supervisory expectations for water risk: mandate financial institutions to map, disclose, and manage hydrological dependencies and impacts across water systems, communities, and value chains, and standardize these requirements in guidance, review processes, and risk assessments.
- Use supervisory dialogue, hydrology sensitive scenario analysis, and stress testing to gradually steer portfolios away from highly exposed business models without credible transition plans, building on early experimentation such as Banco Central do Brasil [17].
- Develop common taxonomies and reporting standards to capture water-related dependencies, impacts, and risks in financial reporting.
- Strengthen data systems for comparability: establish facility- and regional-level datasets on green and blue water, pollution, and reliance on vulnerable storage across sector and geography.

Multilateral and public development banks (MDBs and PDBs)

- Operationalize hydrological macro-financial diagnostics: mandate MDBs and PDBs to systematically integrate hydrological indicators into macro-financial diagnostics across portfolios, linking them to GDP, trade, debt, and distributional variables. While comparable climate-related approaches are advancing, water-focused diagnostics remain nascent and should be scaled as a priority.
- Build on climate finance precedents and task MDBs and PDBs with co-developing common macro-financial norms, methodologies, and taxonomies for hydrological metrics. Establish classifications that flag water-frontier assets and redirect capital towards interventions that stabilize water cycles.
- Strengthen system-wide capacity by upgrading data, modeling, and supervisory frameworks, and supporting finance ministries to integrate green and blue water risks into fiscal and debt management.

Firms and institutional investors

- Align decision-making with hydrological integrity: require large corporates and institutional investors to integrate hydrological metrics into procurement standards, lending policies, and portfolio mandates, reflecting their influence over production models and their local-to-global hydrological impacts.
- Operationalize these standards to accelerate the phase-out of production systems that degrade water cycles, while incentivizing practices that stabilize hydrological systems.
- Redirect capital toward landscapes that underpin water-cycle stability.

Multilateral Environmental Agreements (MEAs) and financing facilities

- Elevate water-cycle integrity within MEAs: mandate MEAs and their financing facilities to recognize water-cycle integrity as a core objective, positioning resilience-critical ecohydrological systems as priorities for investment.
- Cross reference Nationally Determined Contributions and National Biodiversity Strategies and Action Plans around shared hydrological outcomes to create a coherent signal for governments, development partners, and investors.
- Develop integrated metrics capturing hydrological, carbon, and biodiversity functions simultaneously. Building on the Global Environment Facility's work in the Amazon and Congo, strategies can foreground these biomes as ecohydrological infrastructure, essential (intertemporal public assets) for sustaining rainfall regimes and holding back tipping points, alongside their carbon and biodiversity roles. Clearly defining and measuring these functions make the investment signal unmistakable: finance must flow towards safeguarding these systems.

(*photo*: Bernd Dittrich/Unsplash)

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Front cover photograph: A field in Kurunegala, Sri Lanka (Hasti Sadri/IWMI)

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