



LATVIJAS REPUBLIKAS FISKĀLĀS DISCIPLĪNAS PADOME

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RIGA

15.02.2019. No 1-08/215

To _____ No _____

Mrs Baiba Bāne
State Secretary
Ministry of Finance

Mrs Inta Vasaraudze
The Director of
Department of Economic Analysis

On the endorsement of the macroeconomic indicator forecast

Dear Mrs B. Bāne,
Dear Mrs I. Vasaraudze!

According to Article 20 of the Fiscal Discipline Law (hereafter – FDL) medium-term macroeconomic forecasts, including forecasts of growth rate of the gross domestic product (hereafter – GDP), deflator forecasts of the GDP and forecasts of growth rate of the potential GDP shall be developed by the Ministry of Finance (hereafter – MoF). According to the Article 28, Part 2 of the FDL, the Fiscal Discipline Council (hereafter – Council) shall perform an independent assessment of potential GDP and nominal GDP calculation by the MoF.

Article 4, Part 4 of the *Regulation (EU) Nr.473/2013 (21 May 2013) of the European Parliament and the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area*, stipulates that draft annual state budget and draft medium term budget framework (hereafter – MTBF) shall be based on independent macroeconomic forecasts that are prepared or endorsed by independent bodies.

According to the Memorandum of Understanding (hereafter – MoU) between the MoF and the Council, signed on 8 February 2016, the Council shall assume the responsibility of the independent body and endorse the MoF macroeconomic forecasts twice a year – (i) while preparing the Stability Programme, and (ii) the annual state budget and the MTBF.

The MoF's macroeconomic forecast for *the Stability Programme 2019-2022* was first submitted to the Council in 6 February 2019 and presented and discussed at the Council meeting on 7 February 2019. After the Council meeting, the Council prepared a list of follow-up questions for the MoF that were discussion between the parties on 11 February 2019.

On 11 February after discussion between the Council and MoF, *a decision was made to endorse the macroeconomic indicators forecast for the purposes of preparing the SP 2019-2022 with such commentaries:*

The Council agrees that the current output gap is larger-positive than previously forecasted, as the Council has pointed out in previous endorsements. The Council has taken into consideration the changes in GDP data and its price levels after revision of data series for last 10 years.

The Council points to possible risks to the development of the Latvian economy, that have appeared in 2018 and will be present in 2019, including less favourable international trade, lower external demand, Brexit, insufficient progress with implementation of Moneyval recommendations. If conditions would evolve unfavourable, the real GDP growth rate may fall, although in the last forecast it is 0.2 percentage points higher than forecast in October 2018. Furthermore, the consequences of insufficient progress with implementation of Moneyval recommendations could lead to significant risks for further Latvia's economic growth.

The Council does not observe sufficient measures in the Government's work plan to achieve structural improvements in the labour market that would contribute to higher potential GDP growth.

The Council expresses its gratitude for the co-operation and data exchange with colleagues from the MoF.

	2019	2020	2021	2022
Real GDP growth	3.2	3.0	2.9	2.9
Nominal GDP growth	6.4	5.9	5.5	5.5
Inflation (consumer prices)	2.5	2.2	2.1	2.0
GDP deflator	3.1	2.8	2.5	2.5
Potential GDP growth	3.5	3.4	3.2	3.2
Output gap	1.4	1.0	0.7	0.4

Table 1. Endorsed macroeconomic indicators by the Council.

Annex: opinion on the Ministry of Finance's macroeconomic forecast.

Kind regards,

Council chairman

J. Platais

OPINION ON THE MINISTRY OF FINANCE'S MACROECONOMIC FORECAST

This document presents the opinion of the Fiscal Discipline Council (hereafter - the Council) on the macroeconomic forecast prepared by the Ministry of Finance (hereafter – MoF) that will be used for drafting Latvia's Stability Programme (hereafter – SP) 2019/22, which is scheduled to be submitted to the Cabinet of Ministers on mid-April 2019. An early review and endorsement of the MoF's macroeconomic projections by the Council has been agreed upon to support the efforts of the Government during the preparation of the annual SP and the medium term budget framework (hereafter – MTBF).

According to the Memorandum of Understanding, signed on 8 February 2016, the Council has a responsibility to endorse MoF's macroeconomic forecast. The Council assessed the forecast as a whole, and provides an endorsement of the key macroeconomic indicators, which are outlined below. During the endorsement process the Council was presented with detailed information on MoF's forecast, such as the gross domestic product (hereafter – GDP) structure and development scenarios of GDP components. The Council has consulted with external experts to gain a comprehensive understanding of the developments in Latvia's economy.

The Council has a mandate to endorse the forecast of macroeconomic indicators according to the scope of Article 20 of the Fiscal discipline law (indicators are summarised in Table 2 at the end of this document).

	2019	2020	2021	2022
Real GDP growth				
MoF (Feb 2019)	3.2	3.0	2.9	2.9
BoL (Dec 2018)	3.5	3.1	–	–
EC (Jan 2019) ¹	3.1	2.6	–	–
EC (Oct 2018) ²	3.2	2.9	–	–
IMF (Oct 2018)	3.3	3.1	3.0	3.0
Nominal GDP growth				
MoF (Feb 2019)	6.4	5.9	5.5	5.5
BoL (Dec 2018)	–	–	–	–
EC (Oct 2018) ²	5.4	5.7	–	–
IMF (Oct 2018)	5.8	5.7	5.5	5.3
Inflation				
MoF (Feb 2019)	2.5	2.2	2.1	2.0
BoL (Dec 2018)	2.9	2.5	–	–
EC (Jan 2019) ¹	2.7	2.1	–	–
EC (Oct 2018) ²	2.7	2.4	–	–
IMF (Oct 2018)	2.4	2.4	2.4	2.3
GDP deflator				
MoF (Feb 2019)	3.1	2.8	2.5	2.5
BoL (Dec 2018)	–	–	–	–
EC (Oct 2018) ²	2.1	2.7	–	–
IMF (Oct 2018)	2.9	3.2	3.1	3.0
Output gap				
MoF (Feb 2019)	1.4	1.0	0.7	0.4
BoL (Dec 2018)	–	–	–	–
EC (Oct 2018) ²	2.1	1.3	–	–
IMF (Oct 2018)	–	–	–	–

Table 1 Key macroeconomic indicator forecasts by various institutions, % y-o-y. Data sources: MoF, BoL, EC, IMF.

The MoF macroeconomic forecast is largely in line with the forecasts of the European Commission (hereafter – EC), the International Monetary Fund (hereafter – IMF) and the Bank of Latvia's (hereafter – BoL) (Table 1). However, the inflation rate is forecasted lower (in comparison to forecasts by BoL, and EC¹ for 2019) but the nominal GDP growth – higher (even by 1,0 percentage points in comparison to EC).

Although the output gap estimate is increased for the whole-time horizon in comparison to the previous forecast by MoF, it remains below the EC forecast. Both forecasts indicate a likely decline in real GDP growth below potential growth.

In 2018, the financial and transport sectors performed better than expected, we also saw high confidence indicators (above the long-term average) and investments (especially in construction sector, financed by the European Funds). However, in addition to historically low unemployment (since 2009) pushing up wages, **risks of weaker external trade and lower external demand are emerging²**, together

with warnings of reputation crisis in banking sector if prevention of money laundering will not be introduced

¹ European Commission Winter 2019 Economic Forecast. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip096_en.pdf, accessed on 07.02.2019.

² European Commission Autumn 2018 Economic Forecast. Available at: https://ec.europa.eu/info/sites/info/files/economy-finance/ip089_en_0.pdf, accessed on 07.02.2019.

at the level recommended by the MONEYVAL³.

The Council endorses the nominal and real GDP growth forecast for SP 2019/22 with comments. Compared to the previous forecast in October 2018, which was prepared for the MTBF 2019/21, the real GDP growth rate has been raised by 0.2 percentage points for 2019 with no changes for upcoming years (Chart 1). However, negative risks at global extent have increased, resulting in weaker external trade and lower external demand; it could slow down the real economic growth below the forecasted level for 2019.

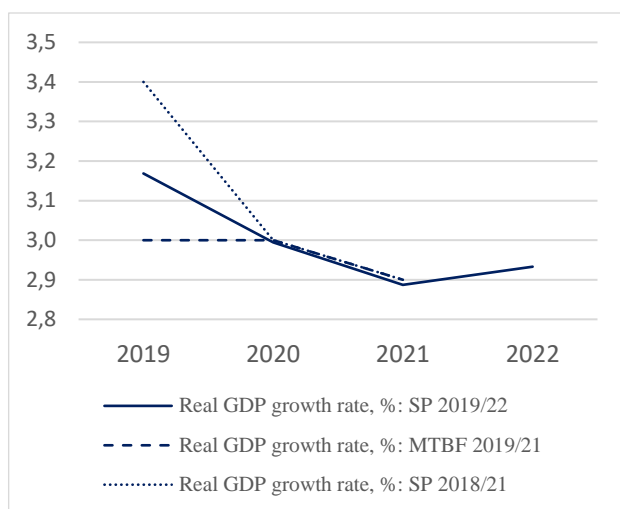


Chart 1 Forecast for real GDP growth, y-o-y.
Data source: MoF.

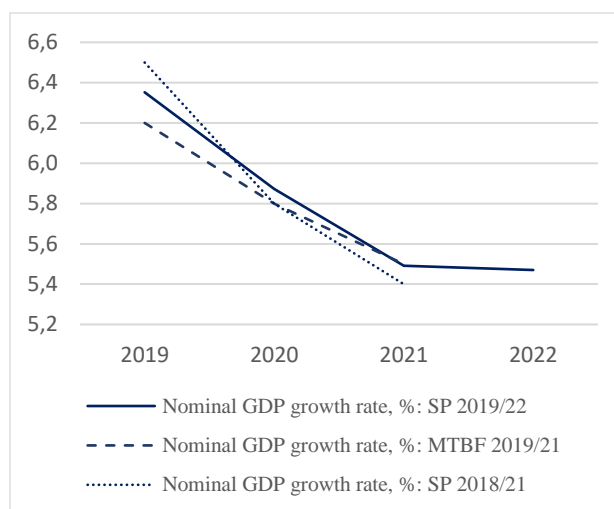


Chart 2 Forecast for nominal GDP growth, y-o-y.
Data source: MoF.

The Council endorses the GDP deflator and the change in the consumer price index (hereafter – CPI) (inflation) forecast for the SP 2019/22 with comments. Since October 2018, there are no changes made to the inflation forecast (Chart 3), however, as already in previous endorsements, the Council emphasizes that the pressure on the wage growth from the labour market remains high and therefore inflation outcome might be above the current forecast, particularly for years 2020 and 2021. The CPI forecasts by the EC (2019) and Bank of Latvia are higher for both 2019 and 2020.

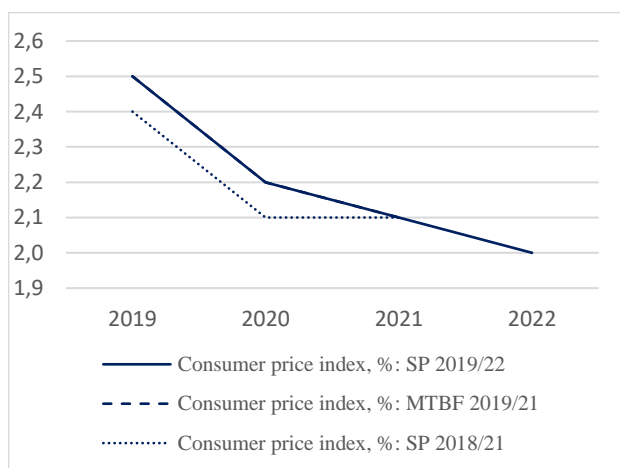


Chart 3 Forecast for inflation, y-o-y.
Data source: MoF.

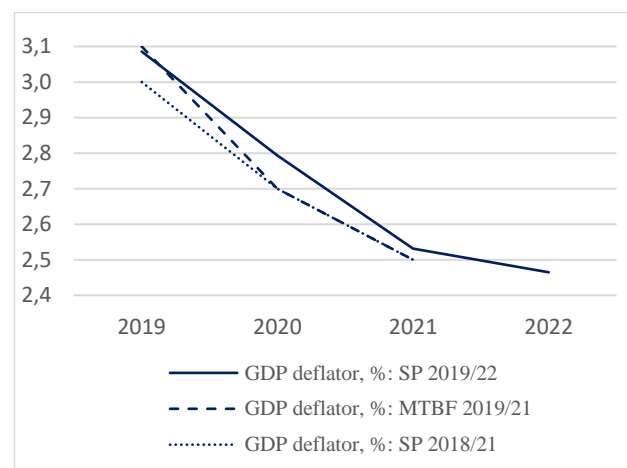


Chart 4 Forecast for GDP deflator, y-o-y.
Data source: MoF.

The Council endorses the potential GDP growth and output gap forecasts for the SP 2019/22 with comments. Potential GDP growth has been revised upwards by 0.1 percentage points for 2019 and 2020, and for 0.2 percentage points for 2022. A 3.0% growth rate has been set for 2023, 2.9% for 2024, 2025 and 2026

³ The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism - MONEYVAL, July 2018. Anti-money laundering and counter-terrorist financing measures. Available at: <https://rm.coe.int/moneyval-2018-8-5th-round-mer-latvia/16808ce61b>, accessed on 07.02.2019.

"After the peak in 2017 of the economic growth in European Union (hereafter – EU), growth has moderated with emerging external demand risks and weaker external trade (domestic demand remains strong)."

(the expanded time horizon is necessary for further calculations of the expenditure benchmark). The Council agrees that the current output gap is larger-positive than previously forecasted, in fact, it could be even larger, knowing the risks of, e.g., price acceleration above the inflation rate currently forecasted by MoF that would deteriorate the productivity and result in lower economic growth potential as well as widening positive output gap. While MoF argues that there are positive structural changes in the labour market, the Council points out that the structural unemployment is high, therefore labour market continues to restrict the potential GDP growth.

Latvia's economic growth currently is in upswing of economic cycle close to its maximum growth level. Although, in 2019, the slowdown of economic growth is probable because of raising risks, the economy will continue to grow in upcoming years. During this time, the Government should implement a restrictive fiscal policy and create a buffer for next – turning downwards – phase in the economic cycle.

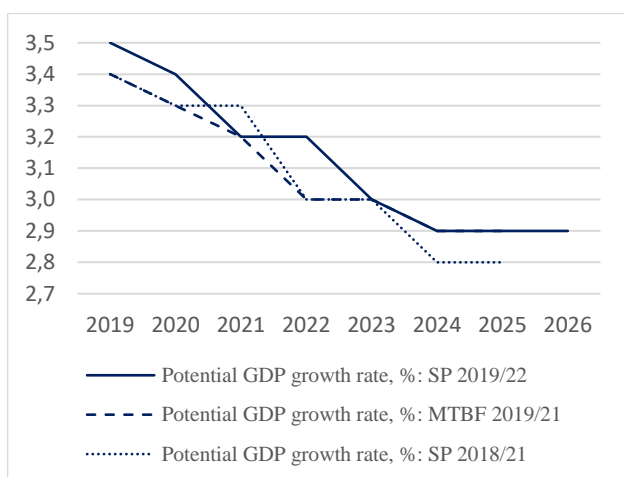


Chart 5 Potential GDP growth, %, y-o-y.
Data source: MoF.

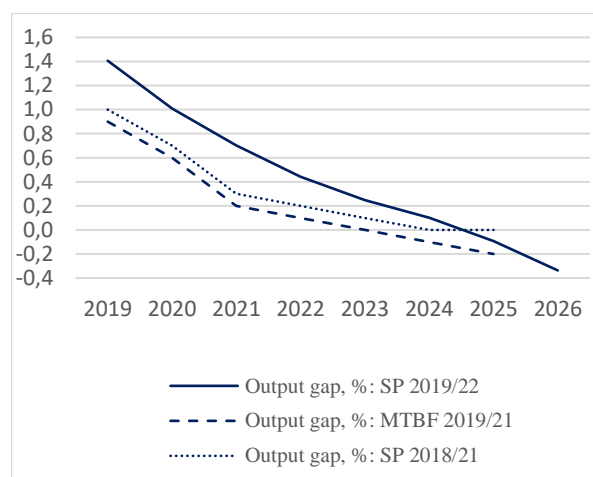


Chart 6 Output gap, % of potential GDP.
Data source: MoF.

	2019	2020	2021	2022
Real GDP growth	3.2	3.0	2.9	2.9
Nominal GDP growth	6.4	5.9	5.5	5.5
Inflation (consumer prices)	2.5	2.2	2.1	2.0
GDP deflator	3.1	2.8	2.5	2.5
Potential GDP growth	3.5	3.4	3.2	3.2
Output gap	1.4	1.0	0.7	0.4

Table 2 Macroeconomic forecast indicators endorsed by the Council. Data available also in MS Excel⁴.

Broadly, the Council considers the MoF's macroeconomic forecasts to be realistic and endorses them.

The Council would like to point out that the SP2019/22 should include the sensitivity analysis, where following negative risks are assessed: decreasing unemployment contributing to wage growth and inflation, unfavourable external circumstance for external trade and lower external demand, effect of Brexit; as well as reputation risks in banking sector. As in the spring forecast last year, the Council has attached an evaluation of yearly macroeconomic forecasts (in MS Excel⁵). The Council encourages the MoF to continue to improve both the sensitivity analysis and the evaluation of previous forecast's deviations.

The Council is also looking forward to MoF's assessment (that is going to be prepared in May 2019) of tax-reform started in 2017 results, incl. effect on economic cycle.

⁴ Macroeconomic indicators. Available:

http://fdp.gov.lv/files/uploaded/FDP_1_08_215_20190215_macroecconomic_forecasts_opinion_Ann2.xlsx, accessed on 15.02.2019.

⁵ Evaluation of the annual macroeconomic forecasts. Available:

http://fdp.gov.lv/files/uploaded/FDP_1_08_215_20190215_macroecconomic_forecasts_opinion_Ann3.xlsx, accessed on 15.02.2019.

In addition, the Council has introduced a new monitoring tool – the heatmap (available online: <http://fiscalcouncil.lv/cycle-heatmap>), to follow on changes of main indicators characterizing the economic cycle. From the analysis it is possible to observe a clear "heating" of the composite index since beginning of 2017, and especially in 2018Q2 and 2018Q3, which is characterized by tension in labour market, historically high capacity utilization in manufacturing industries, high demand in construction, industry and services, as well as above the long term average house price index and economic sentiment (see Annex⁶).

⁶ Heatmap and recognition of economic cycles. Available: http://fdp.gov.lv/files/uploaded/FDP_1_08_215_20190215_macro-economic_forecasts_opinion_Ann4.pdf, accessed on 15.02.2019.

Makroekonomiskie rādītāji / Macroeconomic indicators

				t-7	t-6	t-5	t-4	t-3	t-2	t-1	t	t+1	t+2	t+3	t+4	t+5	t+6	t+7
Nr.	Rādītājs	Indicator	Mērvienība / Unit															
48	Iedzīvotāju kopskaits	Total population	tūkst. / thsd.	2 045	2 024	2 001	1 986	1 969	1 950	1 934	1 917	1 900	1 883	1 868				
49	Iedzīvotāju kopskaita pieaugums	Population growth	%		-1,0	-1,1	-0,8	-0,9	-1,0	-0,8	-0,9	-0,9	-0,9	-0,8				
50	Iedzīvotāji darbspējas vecumā (15-74)	Working age population	tūkst. / thsd.	1 560	1 536	1 496	1 473	1 450	1 423	1 412	1 400	1 389	1 382	1 371				
51	Ekonomiski aktīvie iedzīvotāji	Economically active population	tūkst. / thsd.	1 031	1 014	992	994	989	980	984	984	980	977	969				
52	Nodarbināto skaits	Number of persons employed	tūkst. / thsd.	876	894	885	896	893	895	911	915	916	915	915				
53	Nodarbināto skaita pieaugums	Growth of number of persons employed	%	1,6	2,1	-1,0	1,3	-0,3	0,2	1,8	0,5	0,1	-0,1	-0,1				
54	Līdzdalības līmenis	Participation rate	%	66,1	66,0	66,3	67,5	68,2	68,9	69,7	70,3	70,6	70,7	70,7				
55	Bezdarba līmenis	Unemployment rate	%	15,0	11,9	10,8	9,9	9,6	8,7	7,4	7,0	6,5	6,3	5,6				
56	Bezdarba līmenis, kas neietekmē algu, %	NAWRU	%, y-o-y	14,2	13,2	12,0	10,8	9,7	8,8	8,1	7,5	7,0	6,6	6,2				
Algas un produktivitāte				2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022				
57	Vidējā bruto alga	Average gross wage	EUR	685	716	765	818	859	926	1 004	1 069	1 128	1 184	1 243				
58	Vidējās bruto algas pieaugums	Average gross wage growth	%	3,8	4,5	6,8	6,9	5,0	7,8	8,4	6,5	5,5	5,0	5,0				
59	Reālās produktivitātes pieaugums	Real productivity growth	%	2,4	0,3	2,9	1,7	2,4	4,5	2,9	2,7	2,9	3,0	3,0				
Potenciālais IKP un izlaižu starpības				2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
60	Potenciālais IKP 2010. gada cenās	Potential GDP in the prices of 2010	milj. / mio EUR	19 697	20 184	20 733	21 329	21 968	22 662	23 454	24 275	25 100	25 904	26 732	27 534	28 333	29 155	30 000
61	Potenciālā IKP pieaugums	Potential GDP growth	%, y-o-y	1,4	2,5	2,7	2,9	3,0	3,2	3,5	3,5	3,4	3,2	3,2	3,0	2,9	2,9	2,9
62	Darbspēka devums	Potential labour	%	-0,5	0,1	0,1	0,1	0,1	0,1	0,4	0,2	0,1	-0,1	-0,1				
63	Kapitāla devums	Potential capital stock	%	1,6	1,5	1,4	1,3	1,2	1,2	1,2	1,3	1,3	1,3	1,3				
64	Faktoru produktivitātes devums	Potential total factor productivity (TFP)	%	0,4	0,9	1,2	1,5	1,7	1,8	1,9	2,0	2,0	2,0	2,0	2,0	2,0	2,0	2,0
65	Izlaižu starpība	Output gap	%	0,8	0,7	-0,1	0,0	-0,9	0,5	1,7	1,4	1,0	0,7	0,4	0,2	0,1	-0,1	-0,3
66	Izlaižu starpība	Output gap	milj. / mio EUR	156	151	-20	-1	-199	116	406	341	253	182	118	68	29	-27	-101

Real GDP growth																			
Report: S-Spring & A-Autumn																			
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	
S 2004		7,5	6,2	6,2															
A 2004		7,5	7,5	6,7	6,7														
S 2005		7,5	8,5	7,2	6,9														
A 2005		7,2	8,3	9,1	7,7	7,1													
S 2006		7,2	8,5	10,2	8,5	7,6													
A 2006		7,2	8,6	10,2	11,0	8,9	8,0												
S 2007		7,2	8,7	10,6	11,9	9,6	7,9												
A 2007		7,2	8,7	10,6	11,9	10,5	7,2	6,2											
S 2008		7,2	8,7	10,6	12,2	10,3	3,8	2,5											
A 2008			8,7	10,6	12,2	10,3	-0,8	-2,7	1,0										
S 2009					10,0	-4,6	-13,1	-3,2											
A 2009				10,6	12,2	10,0	-4,6	-18,0	-4,0	2,0									
S 2010				10,6	12,2	10,0	-4,6	-18,0	-3,5	3,3									
A 2010					12,2	10,0	-4,2	-18,0	-0,4	3,3	4,0								
S 2011					12,2	10,0	-4,2	-18,0	-0,3	3,3	4,0								
A 2011						9,6	-3,3	-17,7	-0,3	4,5	2,5	4,0							
S 2012						9,6	-3,3	-17,7	-0,3	5,5	2,2	3,6							
A 2012							-3,3	-17,7	-0,9	5,5	4,3	3,6	3,9						
S 2013								-3,3	-17,7	-0,9	5,5	5,6	3,8	4,1					
A 2013									-1,3	5,3	5,0	4,0	4,1	4,2					
S 2014									-1,3	5,3	5,2	4,1	3,8	4,1					
A 2014										5,0	4,8	4,2	2,6	2,9	3,6				
S 2015											5,0	4,8	4,2	2,4	2,3	3,2			
A 2015											6,2	4,0	3,0	2,8	2,4	3,0	3,3		
S 2016												4,0	3,0	2,4	2,7	2,8	3,1		
A 2016												2,9	2,1	2,7	1,9	2,8	3,0		
S 2017													2,6	2,1	2,7	2,0	3,2	3,5	
A 2017														1,9	2,8	2,1	4,2	3,5	3,2
S 2018															1,9	3,0	2,2	4,5	3,3
A 2018																3,0	2,1	4,6	4,1
Eurostat 05.01.2018.																			
ESA 2010		8,4	8,3	10,7	11,9	10,0	-3,5	-14,4	-3,9	6,4	4,0	2,4	1,9	3,0	2,1	4,6			
ESA 95		7,7	8,8	10,1	11,0	10,0	-2,8	-17,7	-1,3	5,3	5,2	4,1	N/A	N/A	N/A				

	mean error				mean absolute error				root mean squared error						
	CY (spring)	CY (autumn)	YA (spring)	YA (autumn)	2YA (autumn)	CY (spring)	CY (autumn)	YA (spring)	YA (autumn)	2YA (autumn)	CY (spring)	CY (autumn)	YA (spring)	YA (autumn)	2YA (autumn)
2004	2,3	0,8				2,3	0,8				5,29	0,64			
2005	3,0	1,1	4,0	3,5		3	1,1	4	3,5		9,00	1,21	16,00	12,25	
2006	3,4	0,9	5,0	4,2	5,2	3,4	0,9	5	4,2	5,2	11,56	0,81	25,00	17,64	27,04
2007	0,7	-0,2	2,7	1,4	3,2	0,7	0,2	2,7	1,4	3,2	0,49	0,04	7,29	1,96	10,24
2008	-8,4	-3,8	-12,5	-11,8	-12,6	8,4	3,8	12,5	11,8	12,6	70,56	14,44	156,25	139,24	158,76
2009	-4,9	0,0	-20,5	-15,3	-24,2	4,9	0	20,5	15,3	24,2	24,01	0,00	420,25	234,09	585,64
2010	3,2	0,1	2,9	3,7	-1,3	3,2	0,1	2,9	3,7	1,3	10,24	0,01	8,41	13,69	1,69
2011	2,2	1,0	2,2	2,2	3,5	2,2	1	2,2	2,2	3,5	4,84	1,00	4,84	4,84	12,25
2012	3,4	0,7	1,6	2,5	1,0	3,4	0,7	1,6	2,5	1	11,56	0,49	2,56	6,25	1,00
2013	0,3	0,2	0,5	0,6	0,2	0,3	0,2	0,5	0,6	0,2	0,09	0,04	0,25	0,36	0,04
2014	-1,4	0,2	-1,7	-1,3	-1,1	1,4	0,2	1,7	1,3	1,1	1,96	0,04	2,89	1,69	1,21
2015	0,4	0,3	-1,4	-0,2	-1,5	0,4	0,3	1,4	0,2	1,5	0,16	0,09	1,96	0,04	2,25
2016	-0,8	0,2	-1,2	-0,9	-1,5	0,8	0,2	1,2	0,9	1,5	0,64	0,04	1,44	0,81	2,25
2017	1,3	0,4	1,4	1,8	1,3	1,3	0,4	1,4	1,8	1,3	1,69	0,16	1,96	3,24	1,69
2018															
	0,336	0,136	-1,308	-0,738	-2,317	2,550	0,707	4,431	3,800	4,717	3,296	1,165	7,066	5,792	8,186

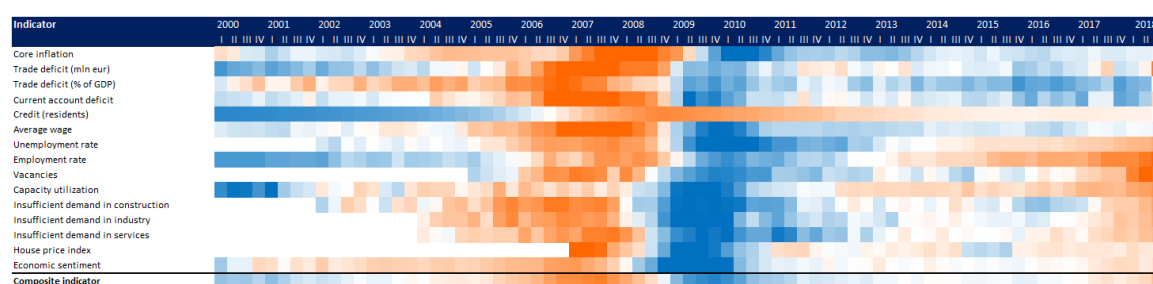
Real GDP growth rate forecast error	Mean error			Mean absolute error			Root mean squared error			
	Current Year	One-year Ahead	Two-year Ahead	Current Year	One-year Ahead	Two-year Ahead	Current Year	One-year Ahead	Two-year Ahead	
	EC (spring)	0,336	-1,308	N/A	2,550	4,431	N/A	3,296	7,066	N/A
	EC (autumn)	0,136	-0,738	-2,317	0,707	3,800	4,717	1,165	5,792	8,186
MoF (budget)	0,078	-1,093	-2,476	1,740	3,478	4,811	2,406	5,671	7,558	

Reālā IKP pieauguma prognožu kļūda	Vidējā kļūda			Vidējā absolūtā kļūda			Vidējā kvadrātiskā kļūda (kvadrātsakne)			
	Tekošais gads	Nākamais gads	Divi gadi uz priekšu	Tekošais gads	Nākamais gads	Divi gadi uz priekšu	Tekošais gads	Nākamais gads	Divi gadi uz priekšu	
	EK (pavasaris)	0,336	-1,308	N/A	2,550	4,431	N/A	3,296	7,066	N/A
	EK (rudens)	0,136	-0,738	-2,317	0,707	3,800	4,717	1,165	5,792	8,186
FM (budžets)	0,078	-1,093	-2,476	1,740	3,478	4,811	2,406	5,671	7,558	

HEATMAP AND RECOGNITION OF ECONOMIC CYCLES

As the economy has grown at faster pace than previously forecasted in both 2017 and 2018, output gap has increased advising to perform restrictive fiscal policy. To understand the development of the economic cycles that would also help to lead the endorsement procedure of the macroeconomic forecast, the Council has constructed a composite indicator of several variables describing changes in cyclical factors. It is published in the Councils homepage – <http://fiscalcouncil.lv/cycle-heatmap> and first discussed at the Councils blog – <http://sekretariats.blogspot.com/2018/12/latvijas-ekonomikas-siltuma-karte.html>.

The composite indicator is calculated as the average of standardized variables. The methodology and steps of data calculation are presented at homepage, mentioned above. At the same time, this analysis is planned to be expanded further, along with other cyclical indicators, and the current choice of these variables is not necessarily the most representative of the economic cycles. We also welcome MoF to comment on variables they find important to be further included.



Annex 4 Chart 1 Economic heatmap.

From the Heatmap presented above, it is possible to observe the "heating" of the composite index since the beginning of 2017, but especially in 2018Q2 and 2018Q3. Previous signs of overheating were at the end of 2005 and early 2006, that time, as it is well known, it was a period before the global economic and financial crisis.

The heating phase of each cycle is characterized by different indicators, e.g. there was a rapidly rising inflation in 2006, which is currently not observed in Latvia. However, as in 2007, **the labour market has heated**, raising employment and activity level, but at the same time there is increasing number of job vacancies pointing to still high structural unemployment component and decreasing cyclical unemployment component. Also, **capacity utilization in manufacturing industries is historically at its highest level** and insufficient demand is no longer a constraint to business.

Even if the *U-turn* will be observed because of negative effects appearing in 2019 (as lower foreign demand, Brexit, tightening labour market, and reputation risks in banking sector), the economic growth is high leading to evidence of economic upswing. As the Fiscal Discipline Council has repeatedly stressed, in times of economic growth, the government needs to plan the fiscal balance of the budget **with a surplus**.