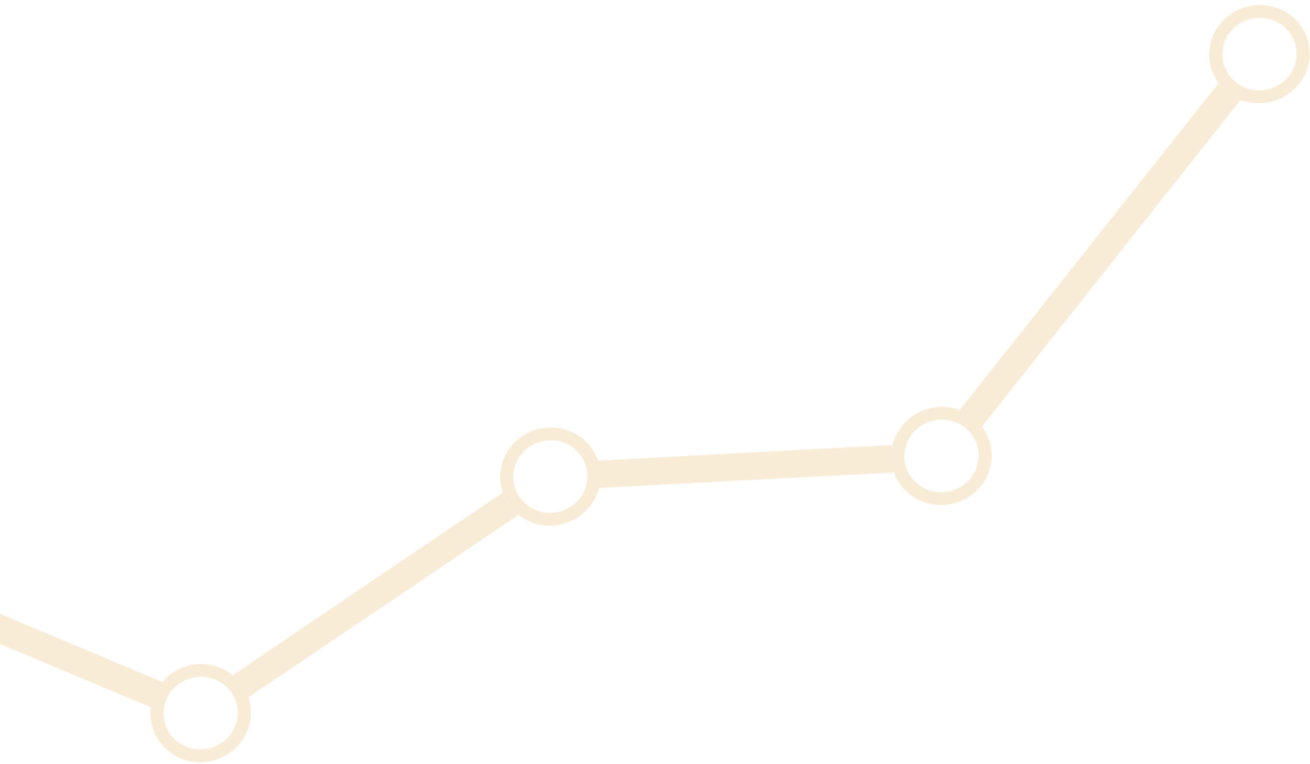


Czech labor market tightness yields only gradual inflation pressures

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The Research Institute for Labour and Social Affairs (RILSA) is a scientific and research institution that conducts independent research in the field of labour, social affairs and occupational safety at the regional, national and international levels. In addition to scientific and research activities, the Institute provides professional advice and consultation and information services in all its areas of activity.

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Summary

- This brief provides a non-technical summary of the work of Sirot, Unal, and Maialeh (2024), which elaborately investigates the inflation dynamics in the Czech Republic with significant emphasis on the influence exerted by the labor market activity.
- The paper asks how Czech labour-market conditions shape inflation and condenses 16 quarterly indicators into two easy-to-track composites: the level of tightness and momentum. Together they capture most of the information in the raw data, while wage series are deliberately excluded at construction to avoid circularity – and later checks show that adding wages does not change the story.
- A clear, gradual link emerges: a one-standard-deviation increase in labour-market activity is associated with about a 3-percentage-point cumulative rise in inflation over three years. The effect builds over time rather than spiking, consistent with constraints and hiring frictions feeding into prices only as tightness persists.
- In expansions, the inflation impulse from tight labour markets is stronger – initially firms absorb some pressure, but the cumulative effect grows and eventually dominates; in mid-phases, recessions can look stickier, yet by the longer horizon expansions deliver materially larger price effects, in some specifications nearly twice to three times those in recessions.
- Accounting for exchange-rate movements and the policy rate leaves the core relationship intact. In fact, once policy lags and expectations are considered, the expansion-phase effect becomes clearer at longer horizons; the domestic capacity/bottleneck channel remains central in an open economy.
- The composite helps successfully track inflation's broad swings in a simple Phillips-curve setup, and the result survives tough tests: dozens of variable-subset recomputations, pseudo-real-time construction, jackknife standard-error propagation, and checks against collider bias. The message holds across crises and calm periods alike.

Importance of the research

- This research gives Czech policymakers solid, real-world evidence to move past the old unemployment-versus-inflation cliché. It points to timing decisions to the business cycle and building capacity-skills, childcare, mobility-so the economy can keep people in work without letting prices run away.
- By showing, in plain terms, how a tight job market nudges prices over time, it strips out the scare stories. That kind of transparency, in our assessment, makes it easier to trust economic institutions and lifts debate above the false choice between "jobs or price stability."
- It provides better planning for everyone. If labour pressure raises prices slowly rather than suddenly, businesses can invest in productivity, the state can target bottlenecks before they bite, and households can plan their budgets with fewer surprises. The focus shifts from crisis response to thinking ahead.

Main findings

When the Czech labour market becomes tight – when fewer people are searching for jobs, vacancies are difficult to fill, and hiring slows – prices tend to rise gradually in the following period. The increase is not sudden, but accumulates steadily, amounting to roughly three percentage points of additional inflation over about three years. This effect is significant enough to influence household budgets and wage negotiations, yet remains moderate and manageable if policy responds in time.

The broader economic context plays a decisive role in how these dynamics unfold. During periods of economic expansion – when firms are confident, order books are full, and demand is strong – the same degree of labour-market tightness tends to exert stronger and more persistent upward pressure on prices. Initially, firms attempt to absorb rising costs by reorganising work, postponing non-essential expenditures, or reducing profit margins. However, when these pressures endure, they gradually pass through to consumer prices and compound over time. In contrast, during economic slowdowns, this mechanism weakens: with cooler demand and less urgency in hiring, price pressures ease more quickly. In short, tight labour markets amplify inflation more noticeably when the overall economy is already running hot.

In constructing their measure of labour-market tightness, the authors deliberately excluded wage data to avoid circular reasoning between wages and inflation. When wages were later reintroduced as a robustness check, the principal results remained unchanged – indicating that the relationship extends beyond pay dynamics alone. Factors such as recruitment bottlenecks, skills shortages, regional mismatches, and training deficits contribute to rising costs even before wages begin to move substantially.

Given Czechia's open, export-oriented economy, the study also examined whether exchange-rate fluctuations or monetary-policy changes might neutralise these effects. They did not. Even after accounting for such influences, the relationship between labour-market tightness and inflation persisted. Over longer horizons, this link became even clearer: the effects of policy adjustments and changing expectations unfold only gradually, allowing the influence of a persistently tight labour market to continue operating beneath the surface.

The findings proved robust under stringent testing. The results held when the labour-market indicator was reconstructed using different sets of variables, when comparing calm and turbulent periods alike, and when measurement uncertainty was explicitly incorporated into the analysis. Across two eventful decades – spanning EU accession, the global financial crisis, the pandemic, and the energy shock – the same pattern emerged: when tightness endures, prices rise somewhat faster than they otherwise would.

For policy and practice, the implications are clear. Policymakers should monitor the full spectrum of labour-market indicators rather than relying on a single headline number. When economic expansion reaches maturity and labour tightness becomes entrenched, early and well-communicated policy responses are essential. Meanwhile, investment in productive capacity – through skills development, childcare, transport infrastructure, and targeted migration – can help ensure that growth translates into higher output rather than higher prices. For households and businesses, the message is reassuring: high employment does not inevitably lead to runaway inflation. Still, a persistently tight labour market tends to nudge the cost of living upward in a slow but predictable manner – one that allows for anticipation, adaptation, and sound planning.

Recommendations

- Watch the whole labour picture, not a single headline number. In this regard, we recommend the CNB to update its composite gauge of labour-market index regularly. It can also be published alongside inflation reports so social partners share the same map. The index in our view can be utilised in forecasts and wage rounds. In case of a persistent elevation in the index, it can be treated as an early warning.
- Run policy by the state of the cycle. When the economy is expanding and the composite stays tight, lean earlier and explain why; when slack appears, let transmission work and avoid over-correction. Exchange-rate moves and the policy rate matter, but they do not erase the domestic signal – so keep the gauge at the centre of decisions.
- Expand capacity where it bites. Close skills gaps in manufacturing and technical trades, speed up re-training, and make childcare, transport, and housing near job centres part of the inflation strategy. Use targeted migration to relieve bottlenecks in shortage occupations while domestic capacity builds. These steps lower the conversion of growth into prices.

- Anchor pay to productivity and persistence, not just last year's inflation. Encourage forward-looking settlements when the labour gauge is high and likely to stay high; avoid automatic indexation that chases temporary spikes. Aim fiscal tools at capacity in hot phases, and at demand support only when slack is genuine. Prioritise investment that lifts effective labour supply and productivity over broad stimulus when the gauge is tight. For firms, the playbook is similar: invest in training and process upgrades when hiring strains, so output rises without passing costs to prices. That is how to keep high employment and tame inflation at the same time.

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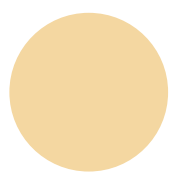
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