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In Search of Money Illusion in CEE Stock Markets: The CAPM Approach

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Abstract

We investigate whether the hypothesis of money illusion can explain the negative or non-existent stock returns and inflation co-movement, and lead to deviations from the CAPM-implied risk-return relation in ten Central Eastern European (CEE) markets. We employ the Cohen, Polk and Vuolteenaho (2005) methodology which allows us to test the hypothesis by utilizing the cross-sectional implications of the Modigliani and Cohn (1979) proposition, and thus avoids the need to discriminate between competing rational explanations. The hypothesis of no money illusion cannot be rejected in any of the researched CEE equity markets. Conversely, we find no significant inflationary effect on the Security Market Line (SML) in eight markets, indicating that the stock return and inflation relationship requires alternative explanations. In Lithuania and Poland inflation positively affects the SML, making safe (risky) stocks relatively underpriced (overpriced) in comparison to the market.