

# **Heterogeneity of agents, transactions costs and the exchange rate**

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The recent empirical and theoretical literature of the exchange rate has discovered the importance of non-linearities. Transaction costs have been recognised as one of the most significant sources of non-linearities. More recently, researchers have also focused on the heterogeneity of beliefs of market participants as being important in understanding the dynamics of the exchange rate. We develop a model of the exchange rate that incorporates these new insights. We show that such a model is capable of explaining the puzzles uncovered over the years by the empirical exchange rate literature. The paper is organised as follows. In section 2 we present the theoretical model. In sections 3, 4, 5 and 6 we analyse its features, while in section 7 we show the empirical relevance of this model. We conclude with some general implications for the exchange rates of the major currencies.

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