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and Exchange Rate Fluctuations**

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Abstract

This essay contains three contributions to the behavioral finance literature. First, we develop a nonlinear exchange rate model, in which traders have the choice between different kinds of trading rules to determine their investment positions. Even in a deterministic setting, the interaction between these rules produces complex dynamics. Second, the deterministic model is buffeted with shocks. With this extension, the model matches various stylized facts of exchange rate dynamics. Within this environment, we study the effectiveness of different kinds of market stabilization policies. Intervention strategies, such as “leaning against the wind”, may reduce exchange rate variability as long as the trading behavior of the agents is correlated. This analysis is preliminary, but one should note that it is one of the very first attempts to deal with such an issue. Third, we add psychological factors influencing the decision-making process of the traders to the model. As a result, we are able to simulate artificial exchange rate data which is difficult to distinguish from real exchange rate data.