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Time-varying threshold cointegration and the law of one price

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Abstract

A theoretical model of the law of one price which allows for seasonality in transaction costs and supply and demand conditions between markets is developed. Bivariate three-regime threshold vector error correction models are applied to natural gas markets to examine seasonality in threshold levels. Results indicate that there are nonlinear adjustments to the law of one price in seven pair-wise markets (Chicago is used as the base market). In the natural gas sector, dynamic threshold effects relative to the Chicago market vary depending on season, geographical location and whether the market is an excess producing or consuming market.

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