

Abstract: This paper extends the Diamond and Dybvig (1983) model to study how the possibility of a bank run affects the investment decisions of banks and asset pricing. It is assumed that a bank run is triggered by extrinsic sunspot variables. The model generates two types of equilibria: a no-default equilibrium and a mixed equilibrium. In the no-default equilibrium, banks promise payments low enough to pay all depositors during bank runs and remain solvent. In the mixed equilibrium, ex ante identical banks choose different strategies, and some banks default with positive probability. The latter equilibrium exists when the probability of runs is sufficiently low.