

Can US afford Trump's Iran war?

It will considerably dent the US budget at a time when the country's public finances are unsustainable

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Updated - March 14, 2026 at 06:00 AM.

Until recently, one of the MAGA movement's most deeply held convictions was that American blood and treasure should not be expended abroad when Americans — and the American Dream — are suffering at home. Yet now the movement's leader, President Donald Trump, has rushed headlong into a costly war against Iran.

The US-Israeli campaign against the Islamic Republic is bound to put a considerable dent in the US budget at a time when the country's public finances already are on an unsustainable path. It is also bound to continue pushing up international oil and gas prices at a time when the US already has an affordability problem. Neither outcome bodes well for US inflation and employment, with the outlook already grim following an unexpectedly negative monthly jobs report.

Even before the start of the Iran war, Trump suggested that the US needed a substantial expansion of its defence budget, proposing to increase it by \$500 billion per year from its current level of \$1 trillion. Now that the US is engaged in a full-scale war that could drag on indefinitely and upend the world's geopolitical map, Trump's case for a significant increase in defence spending would seem to have grown even stronger.

Of course, it is too early to gauge the direct costs of the war, since nobody knows how long and intensive it will be. But we do know that it is currently costing around \$1 billion per day. The bill for the month-long conflict that Trump is anticipating therefore would

approach \$50 billion, with the costs continuing to rise the longer the war continues.

Beyond the direct costs of replacing US ammunition and equipment, there will be other reasons for augmenting the defence budget.

For starters, the Pentagon may need to prepare for a scenario in which the entire Middle East is destabilised, especially if the Trump administration follows through on arming the Iranian Kurds, which will antagonise Turkey and perhaps incite other separatist movements within Iran.

Second, with America's attention diverted, Russia and China could see an opportunity to press their claims in Ukraine and Taiwan, respectively, demanding even greater US military spending to maintain deterrence.

No free lunches

As the Nobel laureate economist Milton Friedman was fond of saying, there is no such thing as a free lunch. Nowhere is this maxim more aptly applied than to military interventions. **The wars in Vietnam, Iraq, and Afghanistan all demonstrated that the US is not good at choosing between guns and butter.** It always seems to want both, even though pursuing both risks generating inflationary pressure.

This is an especially relevant concern today. According to the Congressional Budget Office, **the US can expect to run budget deficits exceeding 6 per cent of GDP as far as the eye can see. That means it is on track to exceed the debt-to-GDP ratio at the end of World War II.**

The Trump administration may not care about America's deteriorating public finances, but bond markets certainly do. Normally when geopolitical tensions are heightened, international investors rush towards the safety of US Treasuries. **But in yet another**

sign that foreign investors might be losing their appetite for US debt, bond yields have been rising since the start of the Iran war.

With the US government financing a \$2 trillion budget deficit and rolling over around \$9 trillion in maturing bonds this year, a loss of foreign appetite for its debt is the last thing it needs. The US also is in no position to absorb an energy-price shock. But that is what seems to be in store. In its fight for survival, the Iranian regime is desperately trying to export the war to its Gulf neighbours and disrupt shipping in the Strait of Hormuz, through which 20 per cent of the world's oil supply passes. On March 4, Goldman Sachs estimated that a five-week closure of this crucial waterway could send oil prices over \$100 per barrel. In fact, that threshold has now already been breached.

Oil price worries

Even though the US economy is far less dependent on oil imports than it was during previous energy-price surges, it certainly would not be immune to a near doubling of the oil price since the start of the year. The International Monetary Fund estimates that, "If energy prices sustain just a 10 per cent increase over a period of one year, this would add 0.4 percentage point to inflation and slow economic growth by 0.1-0.2 per cent" globally. Such stagflationary effects would further compound an already difficult budget situation by reducing tax revenues. The political strategist James Carville famously said that when it comes to winning elections, the economy is everything. If he is still right, a prolonged Iranian war could spell real trouble for Trump's Republicans in November's midterms. If the US does get a combination of a bond-market crisis, higher inflation, and an economic slowdown, Trump and his party may come to regret their betrayal of the "America First" agenda.

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Published on March 14, 2026
