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South Korea | Asia Pacific

Faith in Fiscal

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We expect fiscal policy to take center stage after the presidential election in Korea. We see minimal upside to growth from the first supplementary budget but see a boost from the second one in 3Q25. We still expect BoK to pass the baton to fiscal policy once rates reach 2.0% at end-2025.

Key Takeaways

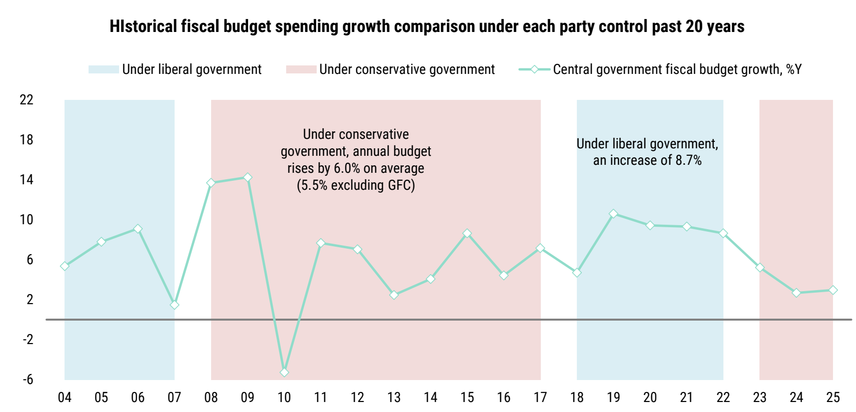
- We see fiscal policy playing a major role in boosting growth after the presidential election on 3 June 2025.
- The National Assembly passed the first-round extra budget on 1 May 2025.
- It came to just 0.6% of GDP, likely lifting this year's growth just 10bp.
- We see room for a meaningful second supplementary budget in 3Q25, likely taking the baton from the BoK.
- The second package could be in a KRW20-35tn range, in our view, giving a 22-31bp boost over 2026.

Exhibit 1: The National Assembly approved the first supplementary budget of the year – KRW13.8tn, with KRW9.5tn funded by KTB issuance

Funding method for supplementary budget, KRW tn	Allocation	Government proposal	Addition from final approval
KTB issuance	9.5	8.1	1.4
Resource from extra reserve, regional bond issuance	2.9	2.8	0.1
BoK receipt surplus	1.2		
Tax receipt surplus from general accounting	0.2		
Total supplementary budget, KRW tn	**13.8**		

Source: MoEF, Morgan Stanley Research

Exhibit 2: Fiscal policy to take center stage after the election: we see room for fiscal expansion after the past three years of fiscal conservatism



Source: MoEF, Morgan Stanley Research

First-Round Supplementary Budget Passed for the Year

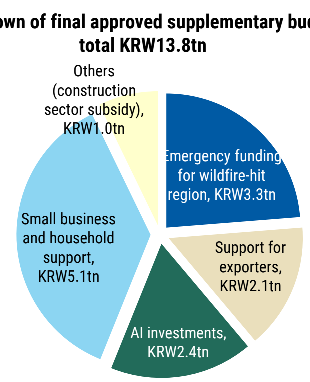
The Korean National Assembly finally approved a long-awaited supplementary budget on 1 May 2025. With the anticipated slowdown in the economy – as well as the unexpected emergency martial law event that took place late last year, which had raised expectations of additional spending since the end of last year – the Ministry of Economy and Finance (MoEF) finally submitted the final proposal bill, sized at KRW12.2tn (0.5% of GDP) on 21 April. The final size approved by the National Assembly was KRW13.8tn (0.6% of GDP).

We believe the boost to this year's growth remains minimal owing to its small size: We see only a 10bp upside impact from the supplementary budget. The government kept the total size of the supplementary budget smaller than our expectation of KRW20tn because of the front-loading of the original budget that is ongoing in 1H25. As of March 2025, the run-rate on government spending had reached 41.7% of this year's original budget – which came to cumulative spending of KRW100.6tn out of the target spending of KRW161.1tn, or 66.8% of the annual budget. For reference, earlier, in January, the BoK had suggested a supplementary budget sized at KRW15-20tn, giving a potential boost to growth of 20bp (see news).

Even so, we think this was a much-needed supplement to this year's spending – after the previous two years of fiscal prudence: The Korean government did not put forth a supplementary budget in 2023-24 under the 'fiscal normalization' agenda. This time it was prompted by the large-scale wildfire that took place in the Southeastern region in March, imposition of harsher-than-expected tariffs by the US, intensifying AI competition and increased downward pressure on small businesses and the household sector in the domestic economy.

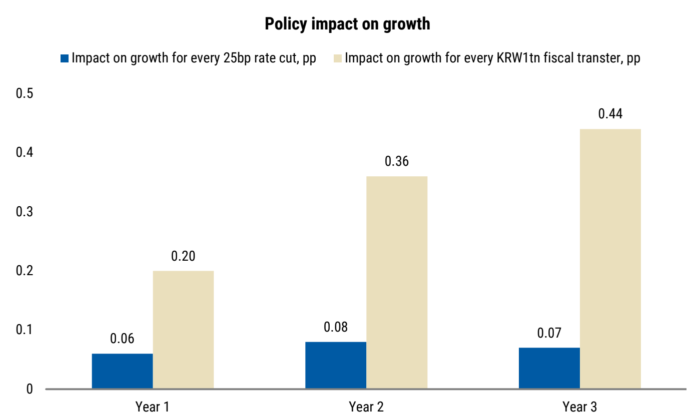
From here, we believe the role of fiscal policy will be amplified: The economic conditions – on both on the external and domestic fronts – appear challenging. Our growth forecast is 1.0%, far below the potential growth level of 2.0% for this year. A policy reversal to fiscal expansion is likely to receive increased recognition and support over the rest of this year, especially after the presidential election on 3 June.

Exhibit 3: First supplementary budget of the year – approved size of KRW13.8tn (0.5% of GDP)



Source: MoEF, Morgan Stanley Research

Exhibit 4: Applying estimated fiscal impulse, we see a 10bp boost to growth this year



Source: BOK20, Morgan Stanley Research *Notes: Results of Bank of Korea Macro-Econometric Model Construction (October 2020)

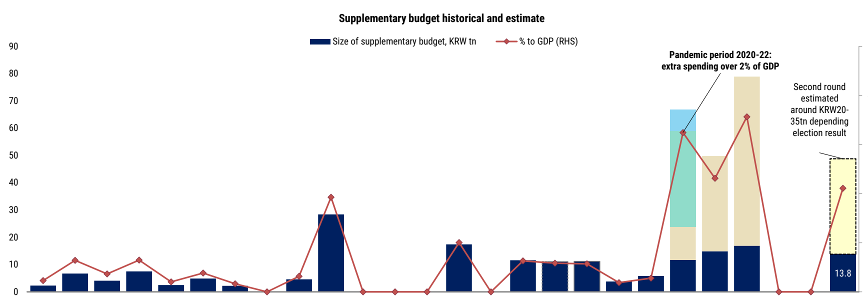
Policy Narrative to Shift to Fiscal Policy after the Election

We think fiscal capacity remains ample this year. Depending on the election result, we see the size of the supplementary budget varying between KRW20tn and KRW35tn in 2H25, on top of the first stimulus passed just this month. Because the previous Yoon administration's fiscal spending was more conservative than usual over the past three years, there is room for an increase at least to a historical average of fiscal spending for whichever party takes office, in our view.

Applying the historical budget growth average over the past 20 years of 7.4%Y, we see KRW18-20tn as a possible size of the second stimulus package. With a liberal assumption – in which each party would expand the budget at a level equal to the historical high of 10% in a year – we see room for KRW35tn (1.5% of GDP). This is also the size that the current leader in the presidential race, Mr. JM Lee, previously proposed for the supplementary budget back in January 2025. This would bring the size of the supplementary budget just over 2% of GDP for the whole year – the level witnessed when the economy struggled with the pandemic shock.

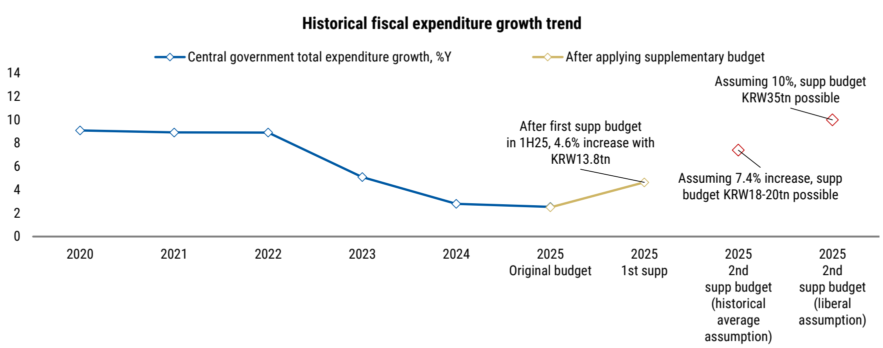
Based on these assumptions, we see a 22-31bp boost to next year's growth from this second stimulus. The realistic timing of the second supplementary budget is for it to be proposed and approved by the latter half of 3Q25. Thus, we see meaningful effects on growth from the second supplementary budget likely being transmitted to the economy more notably from next year, given the transmission time lag.

Exhibit 5: We expect a supplementary budget sized between KRW20tn and KRW35tn after the presidential election in 3Q25



Source: MoEF, Morgan Stanley Research forecasts

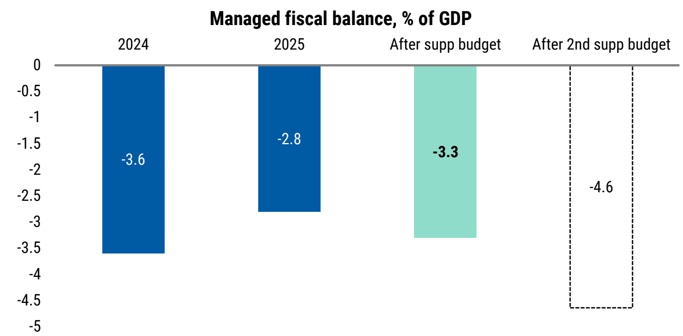
Exhibit 6: We see fiscal room with historical budget growth between 7.4% and 10%



Source: MoEF, Morgan Stanley Research forecasts

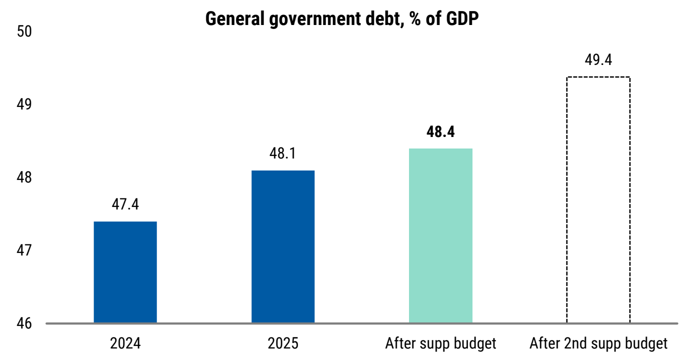
Both the fiscal balance and the central government debt level are set to worsen, yet they should remain at a manageable level. We see the fiscal balance deteriorating at most to -4.6% of GDP from the current -3.3% this year, with the ratio of government debt to GDP reaching 49.4% after the potential second supplementary budget is delivered. But, again, given the grave concerns around weak growth, we think a temporary increase in the fiscal figures is likely to be accepted.

Exhibit 7: We see the fiscal deficit widening to 4.6% of GDP at most this year



Source: MoEF, Morgan Stanley Research

Exhibit 8: This would still keep the ratio of government debt to GDP under 50%



Source: MoEF, Morgan Stanley Research

BoK to Pass the Baton Once Rates Reach 2.0%

We reiterate our view that the BoK will continue to push cuts till the end of this year before pausing at 2.0%: That would be just below the low end of the neutral range but within the accommodative range. After keeping the policy rate unchanged in April as we expected, with a conspicuous dovish tilt, another cut to 2.5% looks to be a done deal, along with the turn toward a bearish stance in view of increased tariff-induced downward pressure on exports and the global growth outlook (see BoK Review: To Come Back with Clarity). At the meeting, we expect a cut in the 2025 growth forecast cut to 1.1% from 1.5% in February. In the pessimistic scenario, we see a cut to 1.0%, the same as our own forecast for this year (see South Korea: Tariff Uncertainties Here to Stay).

The BoK's assumptions in its macro forecasts are likely to have changed dramatically by the coming meeting on May 29. The BoK had assumed global trade growth of 2.9% and exports growth of 0.9% for this year in February. These will likely have gone much lower. The governor already noted at the April post-MPC press conference that the WTO's latest forecast on global trade growth has come down to 0.2% from 3.0%. Given that the BoK has alluded to a neutral rate range of 2.25-2.75%, we expect that it can easily reach below 2.25% by year-end.

Nonetheless, we expect the BoK to pass the baton to fiscal policy once it reaches an accommodative level of 2.0% by 4Q25. Concerns about household debt and unwanted spillovers onto the housing market are likely to return, convincing the MPC to take a cautious stance and observe the positive effects on the economy from the previous six cuts in this easing cycle.

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