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## Why Has Korea's Stock Market Gone Wild?

President Lee Jae-myung is taking on entrenched family interests.

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*By S. Nathan Park*

Since Lee Jae-myung won South Korea's presidential election on June 3, the Korean stock market has been on a tear. On June 2, the Korea Composite Stock Price Index (KOSPI)—the weighted index of all common stocks traded in the Korea Exchange—closed at 2,698.97. Around two months later on Aug. 4, the index closed at 3,147.75—a remarkable 16.6 percent increase, outpacing Japan's TOPIX index (which saw a 3.7 percent gain) and even the United States' Dow Jones Industrial Average index (6.7 percent gain) in the same period.

Some of this gain comes from a simple sigh of relief that South Korea's period of uncertainty after the self-coup attempt by impeached former President Yoon Suk-yeol is over. Yet the honeymoon rally for Lee may represent something more durable. During the presidential election campaign, he ran on a pledge that he would usher in the “KOSPI 5000 era.” Although it is still early in Lee's presidency, he's already following through with policies.

Historically, the South Korean stock market has delivered poorer results than the fundamentals of its corporations suggest, in a phenomenon termed the “Korea discount.” Typically, a calculation called the price-to-book multiple—i.e., market price per share divided by a company's book value per share—is used to determine if a company is overvalued or undervalued. The multiple is usually higher than 1, because the price of a stock incorporates both a company's current assets (represented by book value) and the company's expected future earnings.

But currently, the South Korean stock market has a forward price-to-book multiple of 0.98, while the same number for the Japanese stock market is 1.5 and the equivalent for the Taiwanese stock market is 2.3. Stated differently, a stock for a publicly traded Korean company trades at two-thirds of the price relative to a stock for a Japanese company with the same level of assets and approximately 43 percent of a Taiwanese company with the same level of assets.

It is a strange phenomenon for an economy known for being on the bleeding edge of future technologies such as semiconductors, electric vehicle batteries, and solar panels—which should cause investors to place a high value on Korean companies’ future prospects.

The Korea discount has persisted because of South Korea’s law and policies that favor the founding families of *chaebol* groups, the megaconglomerates that dominate the Korean economy.

In the United States, for example, it is taken as a given that the chief task of an executive of a publicly traded company is to deliver value to its shareholders by pushing up its stock price.

Not so in South Korea—because Korean executives are either themselves members of the founding family or answer only to the founding family, whose control of the company is never threatened, regardless of its stock performance. Through complex and opaque cross-holding structures, the founding family of a chaebol group typically controls dozens of companies without necessarily holding a majority of the issued shares. This allows members of the chaebol founding family to take measures that inure solely to their benefit while damaging ordinary shareholders.

As an attorney, I was part of the legal team that dealt with one of the most notorious examples of such an abuse. In 2015, the Samsung group—South Korea’s leading chaebol, known globally for its smartphones and semiconductors—orchestrated a merger between two of its key affiliates, Samsung C&T and Cheil Industries. Like many chaebol groups, the Samsung Group is comprised of around 80 companies, including 17 listed companies. Although each listed company has its own board of directors as a formal matter, they are all ultimately controlled by the Lee family, which founded the group in 1938.

In 2015, Lee Kun-hee, the patriarch of the family, was on his deathbed. Before the elder Lee passed away, the Samsung Group devised a plan to pass down the control of the group to the heir apparent, Lee Jae-yong, while minimizing the potential estate tax that would otherwise run to the billions of dollars. The Samsung Group’s plan was to deliberately hurt the share price of Samsung C&T, the group’s de facto holding company, and inflate the share price of Cheil, which was controlled by the younger Lee. Then Cheil would merge with C&T, effectively acquiring C&T on the cheap.

Samsung’s execution of the plan led to absurd movements in the share price of Samsung C&T. At one point, Samsung C&T’s share price implied that the company’s value was lower than the value of its shareholdings in other Samsung affiliates—as if a coat with a \$100 b

ill in its pocket was being valued at \$85. Then Cheil acquired Samsung C&T based on the

nonsensically low share price, permanently destroying the chance for Samsung C&T's minority shareholders to see their holdings recover their value.

Even though the merger clearly hurt Samsung C&T's minority shareholders, Samsung's founding family was able to railroad Samsung C&T into voting in favor of the merger, in part by bribing then-South Korean President Park Geun-hye to pressure the National Pension Service, the second-largest shareholder of Samsung C&T, to approve the merger.

This scandal later grew into international litigation, with U.S.-based hedge funds Elliott Associates and Mason Capital Management, which were minority investors in Samsung C&T, suing the Korean government for damages. I was one of the attorneys who represented Elliott Associates, which prevailed against the Republic of Korea in an arbitration facilitated by the United Nations Commission on International Trade Law in Geneva, Switzerland, held in November 2021.

Another example is the 2022 initial public offering (IPO) of LG Energy Solution, a leader in electric vehicle batteries that holds more than 14 percent of the global EV battery market. Until 2021, LG Energy Solution was a division of LG Chem, which also operated divisions for petrochemicals, advanced materials, and life sciences. But in December 2020, LG Chem spun off its profitable EV battery division into the separate company called LG Energy Solution.

Then in January 2022, LG Energy Solution went public. The IPO, the biggest in South Korean history, raised \$10.8 billion. But it was also a symbol of the distortion that causes the Korea discount.

Even as LG Chem's EV battery division was emerging as a global leader, the share price for LG Chem never fully reflected the forward-looking value of its EV battery division, because investors were wary of the potential predatory behavior by the LG group's founding family.

After the IPO, LG Chem investors were left with a husk of a company without its most valuable division. The peak share price for LG Chem in February 2021 was more than 1 million South Korean won per share; just over a year later in March 2022, it dropped to as low as 437,000 won. But the drop in share price meant little to LG's founding Koo family, which controls both LG Chem and LG Energy Solution, while the LG Group as a whole became \$10.8 billion richer.

South Korea's weak corporate governance laws enable such predatory behavior. In the United States, for example, Jeff Bezos cannot simply spin off Amazon Web Services (AWS), the cloud computing service that is Amazon's most profitable division, make himself the largest shareholder of AWS, and take it public. Doing so would provoke an instant and massive

shareholder litigation campaign from Amazon's shareholders that would stop such transactions dead and likely result in personal liability for Bezos, because engaging in transactions that clearly damage minority shareholders constitutes a breach of fiduciary duty on the part of controlling shareholders.

This was not the case in South Korea until very recently. On July 3, the Lee Jae-myung administration passed an amendment to Article 382-3 of the Commercial Act to expand the scope of duty for boards of directors from "company" to "company and shareholders." The amendment also mandated directors to "protect the interest of all shareholders and treat the interest of each shareholder fairly."

In other words, the amendment precludes the board of directors from taking steps that arguably benefit the company—or, effectively, the company's controlling shareholders—at the expense of the company's minority shareholders.

In the Samsung C&T merger, for example, the board of Samsung C&T defended its action by claiming that the merger would stabilize the Samsung group's ownership structure and make it less vulnerable to takeover attempts from foreign hedge funds such as Elliott or Mason. Under the new regime, railroading a vote based on this type of argument would expose members of the board to personal liability for breach of duty—and potentially criminal liability for occupational breach of trust.

The July change to the Commercial Act contained other measures to protect minority shareholders. Larger public companies are mandated to hold online shareholder meetings and online voting to allow easier participation by shareholders. When electing auditors, the controlling shareholders and related persons cannot exercise more than 3 percent of the votes. Shareholders of a parent company can now bring a class action lawsuit against a director of a subsidiary company. The amendments also impose greater disclosure requirements as to board minutes and the company's ownership structure.

The Lee administration has said that it will pass additional laws to promote South Korea's stock market. The government pledged that it would push companies to issue more dividends, in part by mandating companies to extinguish most of their treasury stocks. Other new laws would place greater scrutiny on stock market manipulation and enhance criminal penalties. With Lee's Democratic Party holding a majority in the National Assembly, South Korea's unicameral legislature, the proposed bills are likely to be passed in the near future.

If these reforms could usher in a fundamental shift in investor attitudes toward the South Korean stock market, the result may be revolutionary. For Korean small cap investors, the investment of choice has long been real estate, because the stock market has been seen as

prone to manipulation and predation from the powerful chaebol families. A long-term investment strategy like the ones commonly used in the United States is all but impossible, given that, say, an LG Chem investor who bought stocks based on the company's prospect on EV batteries could wake up one day with stocks in an LG Chem that no longer has an EV batteries division.

For international investors, traditionally cautious of investing in a country that produced such weak returns, an assurance that they will be protected from chaebol families' abuse may provide the comfort they need to bet on the prospects of South Korea's leading technology companies.

With more money entering the market, a big, sustained run for South Korean stock market is not difficult to imagine. If the Korea discount disappears and the country's stock market achieves a price-to-book ratio that is comparable to its Asian industrial peers such as Japan or Taiwan, that alone would push the KOSPI index past 5,000 from the current level of around 3,100.

The stock market reform may also have a positive side effect: controlling South Korea's real estate market. Real estate regulation has long been the Achilles' heel of South Korea's liberals, who struggled to control the country's economic growth fueling real estate speculation. South Korea's world-class response against the COVID-19 pandemic kept its economy humming, but much of the excess capital generated by the roaring economy poured into real estate, causing a runaway increase in the cost of housing. During President Moon Jae-in's five-year term from 2017 to 2022, average apartment prices in Seoul rose by an eye-watering 83 percent.

Although Moon remained popular until the end of his presidency, the grievance over the rising cost of housing and property tax allowed a knife's-edge win in the 2022 presidential election for conservative Yoon Suk-yeol. If Lee's stock market reform can break the power of chaebol families and divert capital away from real estate, then he has the chance to solidify a generational shift in both South Korean economy and politics.

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