Brazil Raises a Key Rate by 3 Points

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By SIMON ROMERO

Brazil's central bank surprised investors yesterday and raised a crucial interest rate by three percentage points, continuing an aggressive effort to halt the decline in the value of the nation's currency.

The bank's monetary policy committee raised overnight interest rates to a three-year high of 21 percent, from 18 percent, in a move aimed at keeping short-term investment in the country by offering higher returns on domestic bonds. The increase, the first in 15 months, came as tension builds ahead of the runoff election Oct. 27.

Brazil's currency, the real, which was down 3 percent earlier yesterday, recovered to close down half a percentage point at 3.82 to the dollar. On the São Paulo stock exchange, the main index fell 4.5 percent as concerns mounted over the effect of higher borrowing rates on the economy.

Investors were initially critical of the central bank's decision, which was characterized as an unexpected move in the middle of the standoff between Brazil's government and financial institutions speculating about the direction of the real.

"Perhaps the central bank blinked," said Alexandre Schwartsman, head of economic research at Banco BBA Creditanstalt in São Paulo.

Mr. Schwartsman and other analysts criticized the rate increase, saying it came at a time when concern was growing over the effect of higher rates. Brazil has traditionally had some of the world's highest interest rates but when adjusted for inflation, rates had stabilized and begun to decline in recent years.

The government has kept rates high in a bid to stabilize markets, part of a policy supported by the International Monetary Fund, which recently offered to lend Brazil $30 billion. But the higher interest rates combined with the currency's slide have led to ballooning debt costs.

Differing from some of their counterparts in the United States, few investors in Brazil are worried about a default of domestic debt as long as the central bank is able to roll over bonds in the overnight market or redeem debt by printing money, measures that would inevitably fuel inflation. Still, analysts are worried about the costs of additional rate increases. Yesterday's increase, Mr. Schwartsman said, could cost the government in interest payments the equivalent of 1.8 percent of gross domestic product, limiting its ability to alleviate social tensions with public spending.

Analysts said yesterday that if the strategy of Arminio Fraga, the president of Brazil's central bank, is to work, rates should not remain high for long. Seeking to prevent wide swings in the currency, Mr. Fraga has become more assertive in recent days.

Last Friday, for example, the central bank made it more costly to bet against the real by increasing the amount of reais that banks must keep as reserves. That decision fueled a rally in the currency's value on Friday but by yesterday it was clear that traders were ready to test the real again.

"At least Fraga is sending a clear message that he has tools available with which to fight," said Ignacio Sosa, principal manager of OneWorld Investments, a hedge fund based in Boston.

The central bank said yesterday that it raised rates because of "worsening expectations for inflation" but it also mentioned the "pronounced depreciation of the currency."

The real, which briefly fell to a low of 4 to the dollar last week, has declined 40 percent this year.

A weaker real has raised the cost of imported goods and contributed to a small increase in inflation. But the concerns over price increases are not responsible for most of the market's volatility. Instead, investors are nervously awaiting the outcome of the presidential runoff election.

José Serra, the candidate favored by supporters of Brazil's centrist government, continued to trail Luiz Inácio Lula da Silva of the left-leaning Workers Party, in polls released over the weekend.

Mr. da Silva has provided few details of his plans for crucial positions at the central bank and finance ministry aside from insisting that Mr. Fraga, a former associate of the financier George Soros, must go.

Still, Mr. da Silva is thought to have warmed to the idea of granting greater independence to the central bank, according to a report over the weekend by a prominent columnist, Elio Gaspari. The move could bring calm to the markets if the appointee is agreeable to investors.

Several people have been mentioned, including Henri Philippe Reichstul, whose experience in the 1970's with a revolutionary group brings him respect with some factions of the Workers Party. Mr. Reichstul, an Oxford-educated economist, has since become one of Brazil's most respected business executives.

"A more independent central bank with the right person at its helm would be a striking example of the new government's wish for stability," said Murillo de Aragão, Brasília-based political consultant with LatinSource, a consulting firm in New York..