the joint venture between Polynesian Airlines and Virgin Blue, will be profitable.

On the expenditure side, the budget will have to accommodate the second and third phases of major public service salary and wages increases over the next two financial years. The recent restructuring of government departments is not expected to result in short-term budget savings, pending the completion of operational logistics with management, staffing, operating and capital structures, and physical locations. Counterpart costs for ongoing and new institutional strengthening projects and sector reforms are expected to continue over the medium term, as well as support for the new dialysis unit. Subsidies to state-owned enterprises and other services provided by third parties (non-core department activities), which have accounted for around 30 per cent of total domestic expenditures, will continue to undermine budget outcomes. On the other hand, however, the phasing-out of debt repayments on behalf of Polynesian Airlines and the completion of sporting infrastructure for the 2007 South Pacific Games could provide much needed savings for reallocation to other commitments. Also important will be the efforts of government to cut back on supplementary budget expenditures unless supported by adequate revenue, and adopting a framework of hard budget constraints within which departments are made accountable.

Inflation

Inflation averaged just under 3 per cent per annum over the period 1995–2001. The combination of lower prices resulting from the reductions in tariffs and duties, modest depreciation of the currency, as well as the favourable conditions for domestic supplies enabled the economy to absorb price increases, especially of imports (petroleum etc). Since 1999, however, there has been an upward trend dominated by movements in prices of local produce and petroleum. For the twelve months to June 2005, the annual average inflation rate was 7.8 per cent, about