Could Britain go bust? Or, more precisely, could the government fail to meet its debt obligations? And could that fate befall the next government, whatever its political complexion, if it does not take early action to bring the budget deficit under control? The short answer to the first question is "no, as long as Britain has its own currency." The explanation is that it can borrow from the central bank, which is a state-owned concern and cannot refuse.

According to some reports, David Cameron and George Osborne have been anxious that the budget deficit is so large that at some stage during the next Conservative administration there will be a Day of Judgment. Investors will flee en masse from British government securities. By declining to take up any new issues of the government's debt, they will force it to cancel contracts, sack civil servants and withdraw social security benefits. The worries think that Cameron's Britain could end in the same mess as Arnold Schwarzenegger's California, where the processes of fiscal disintegration are advanced.

But California's government is the government of a state of the US, not the government of a sovereign state with its own currency. California does not have its own tame central bank or its own officially regulated commercial banking system. For Britain's national government, as opposed to California's state government, the banking system is "the debt buyer of last resort".

The penalty for excessive deficits would not be national bankruptcy as such. Instead, the penalty would come in the form of politically unpopular inflation. When a government borrows from the banks, they credit the sum borrowed to its bank deposit and the government then spends it by buying goods and services from the private sector.

As these extra deposits can be spent an indefinitely large number of times in future, they are also money. If too much money is created relative to the economy's ability to produce, if the rate of money-supply growth is well above the trend rate of growth of output, then inflation will emerge. The monetary financing of budget deficits can always avert national bankruptcy. But if monetary financing is on an excessive scale, the consequence will be high inflation.

These ideas were well understood in the years running up to the 1979 election, not least because they had been implicit in the International Monetary Fund's programme for the restoration of the UK's solvency in late 1976. In 1980, the Chancellor of the Exchequer, Geoffrey Howe, translated them into a control framework known as the Medium-Term Financial Strategy (MTFS).

The strategy had two prongs, fiscal and monetary. Numbers were laid down for the budget deficit and the rate of money-supply growth for the four years to 1983/4. Both the budget deficit and the rate of money-supply growth were to be reduced, with the explicit aim being that the lower money supply growth would lead to much less inflation than in the 1970s. As Mrs Thatcher herself made clear, the government was unequivocal in its determination to maintain the downward path for the deficits and money growth. Indeed, the MTFS was the most important policy expression of Mrs Thatcher's boast that "the lady is not for turning".

Unhappily, the economic downturn of 1980 undermined tax revenues. By early 1981, forecasters expected the original MTFS target for the budget deficit to be exceeded by a wide margin. Almost all political commentators thought that the MTFS would be dropped and that the lady would turn, not least because of the prevailing Keynesian orthodoxy that action to lower the budget deficit would further deflate an economy already in recession.

But the MTFS was retained and the lady did not turn. Howe raised taxes by three per cent of GDP in what may have been the most controversial budget of the 20th century. Two Cambridge professors organised a letter to The Times from 364 academic economists, forecasting that the increase in taxes would aggravate the recession, wreck the economy and cause social unrest. In fact, demand and output started to recover within a few months of the budget and the Thatcher government's reputation for sound public finances was thereafter never in doubt. The 364 looked ridiculous.

The MTFS, dropped by Gordon Brown when he became Chancellor in 1997, needs to be reintroduced. Osborne's speech to the Conservative Party conference was brave and admirable in its recognition that public expenditure must be reduced. But the Conservatives' reputation for economic competence would be further enhanced if they included plans for a new MTFS in their election manifesto.