The strains are back in the euro zone. The euphoria in stressed government-bond markets generated by the European Central Bank’s two injections of cheap three-year funds to the region’s banks has given way to renewed anxiety about whether Spain and Italy can finance themselves in the bond market.

In an analysis published on Thursday, Moody’s Analytics said borrowing costs in both countries, as measured by 10-year bond yields, “are now above levels that can be sustained, given the weakened state of the countries’ public finances.” In its view, Italy’s current borrowing costs are less manageable than Spain’s.

Most analysts, however, still believe further bailouts can be avoided. A survey of 29 analysts conducted by Reuters on Thursday showed they assigned on average a 25% chance of Spain needing a bailout and 13% for Italy. Part of the reason many think bailouts are unlikely is that the countries may be too big to save.

For now, market concern is more concentrated on Spain, which in some ways appears the more tractable problem.

Europe’s bailout funds, probably helped by some new resources of the International Monetary Fund, could stretch to cover Spain’s borrowing needs. The sheer size of Italy’s government-debt burden—123.4% of gross domestic product at the end of this year, according to the IMF—means that, as things stand, some analysts argue that only the ECB has the firepower to staunch a crisis there. Yet the ECB’s own guns haven’t been firing magic bullets.

Only a fraction of the three-year money the ECB has lent to banks since December under its Long-Term Refinancing Operations has been channeled to troubled government-bond markets (though it has helped the banks). In any case, this route to salvation has a downside. Most bank bond purchases have been of debt issued by their own governments, and this reinforces the interdependence of weak banks and weak governments that has deepened the crisis over the past two years.

The effectiveness of ECB purchases of government bonds through its Securities Market Program has also been weakened, analysts say, by Greece’s debt restructuring, where the ECB was treated better than private investors.

Since then, analysts say some investors have concluded that the more the ECB buys of a government’s bonds, the more private bondholders will be subordinated. The risk is therefore that as soon as the ECB appears in the market, private investors will disappear.

That doesn’t rule out further ECB purchases, but may raise the bar before they take place. In a report published Thursday, analysts at Credit Suisse argued that "saying that the ECB does not have the will (or perhaps more plausibly the means) to save itself...is a very poor call indeed."

Apart from the ECB, what is left in the armory? If they have a choice, European officials would delay any bailout until the permanent European Stability Mechanism replaces the current temporary fund, the European Financial...
Stability Facility, later this year. The ESM has several advantages: One is that, because it has its own capital, it can move into action more rapidly than the EFSF; another is that lending by the ESM has no impact on the balance sheet of the creditor governments.

European governments are also eager to avoid a full-fledged conventional bailout for Spain—in the style of Greece, Ireland and Portugal—even if things get tougher, analysts say. It is expensive, would exhaust resources for other countries and cut off Spain from market access.

One idea being mooted is for bailout money to be directed toward boosting the capital of Spain's shaky banks, though a spokesman for the European Commission insisted Thursday that there are no plans for providing such support.

Such aid would come under less-onerous conditions than a conventional bailout, which would focus on the government budget. According to confidential European Union documents, the conditions for bank-recapitalization loans would mostly be directed to specific institutions and the financial sector.

But any such funds would, under current euro-zone rules, have to be lent via the government. That increases government indebtedness, and reinforces the linkages between the financial health of the governments and banks that we mentioned earlier.

One way to break this link would be to allow the bailout funds to lend directly to the banks—as IMF Managing Director Christine Lagarde suggested Thursday. Yet Germany, the funds' main paymaster, has blocked previous efforts to allow this and there is no indication of any concessions soon.

There are other alternatives now available.

Spain could draw on one of the precautionary credit lines now permitted. According to confidential EU guidelines, these could typically amount to between 2% and 10% of gross domestic product—in Spain's case that would be more than €100 billion ($131 billion)—and more might be available from the IMF.

The bailout funds can also now buy bonds from the secondary market, or even participate in bond auctions, where, according to the guidelines, they would be permitted to buy as much as half of any new issue.

The outcome of these approaches is uncertain.

One key to their success would be the prospect that Spain's government could retain access to investors. That prospect would be enhanced by optimism about Spain's economic prospects, which for the moment is in short supply.

One obstacle is that Spain's euro-zone partners can't agree over whether the country needs more austerity (the German view) or less (the view of most of the rest).

On the other hand, it isn't clear the financial markets have settled on a consistent view of this question, either.

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