ECB CANNOT COME TO ITALY'S RESCUE WITHOUT EU BAILOUT - SOURCES

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NUSA DUA, Indonesia (Reuters) - The European Central Bank won't come to Italy's rescue if its governments or bank sector run out of cash unless the country secures a bailout from the European Union, five senior sources familiar with the ECB's thinking told Reuters.

Italy has seen its borrowing costs surge on financial markets since its new government unveiled plans to increase its budget deficit late last month, defying EU rules and reawakening concerns about its huge pile of public debt.

The sources, present an economic summit in Indonesia, said Italy could still avoid a debt crisis if its government changed course but should not count on the central bank to tame investors or prop up its banks.

This is because EU rules do not allow the ECB to help a country unless this has already agreed on a rescue "programme" - political jargon for a bailout in exchange for belt-tightening and painful economic reforms, an option the Italian government has firmly rejected.

Any attempt to circumvent those rules would damage the ECB's credibility beyond repair and undermine acceptance of the monetary union in creditor countries, such as Germany, the sources said.

"Its a test-case to show Europe and its mechanisms work," said one of the sources on the sidelines of the International Monetary Fund's annual meetings in the Indonesian resort town of Nusa Dua.

If Italy did secure a bailout, the ECB could then buy its bonds on the market via Outright Monetary Transactions, a so far unused policy tool unveiled in 2012 to quash speculation on a euro break-up.

An ECB spokesman declined to comment.

FLASHPOINT

The sources warned that Italian banks, with 375 billion euros (£329.3 billion) of domestic government debt on their balance sheet, were the possible flashpoint.

This is because they relied on those government bonds as collateral to secure cash at the ECB, including some 250 billion euros worth of long-term loans.

If Italy, like Greece, were to lose its investment-grade rating, the bonds that the banks used would become ineligible for regular ECB lending, as well as for the ECB's bond-buying stimulus programme.

Banks that don't have alternative collateral of good quality would then need to apply for a lifeline known as Emergency Liquidity Assistance, supplied by the Bank of Italy.

"There are some banks that are actually in pretty good shape so it wouldnt be all of them (requesting ELA)," another source said.

But even ELA could run into constraints after a while if reliance on grew too high.

As ELA can only be granted to solvent banks, the ECB's Governing Council could require that an economic programme is in place in Italy before it gives its all-clear to large amounts of ECB cash being disbursed, much like it did in Greece.

The ECB froze the amount of ELA available to Greek banks in the summer of 2015 when Alexis Tsipras' leftist government refused to agree to a bailout, leaving him with little choice but to close the banks.

"We wouldn't want to give out cash to the banks only for it to be taken abroad," a third source said.

Before that even happens, depositors and lenders would have likely cut ties with Italian banks in anticipation of the downgrade, triggering a liquidity crisis, the sources said.

Italy's debt is rated two notches above junk by three of the four ratings agencies recognised by the ECB, and three notches above that key threshold by the remaining one, DBRS.

Moodys and S&P Global are due to provide an updated opinion on Italys credit rating in the second half of October, with analysts saying that around one downgrade is already priced in.

(Editing by Toby Chopra)

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