This thesis overviews and discusses the issue of nonperforming loans in general and in China, and financial sector development from the beginning of Deng Xiaoping's reform era in 1978. The focus is put on the underlying institutional framework as it is found to be one of key contributing factors of NPLs in China. Utilizing a sample of 23 countries over the period 2000-2009, we estimate the impact of macroeconomic determinants on nonperforming loans. One of the regressors, output gap, is estimated via Kalman filtering technique based on the multivariate unobserved component (MUC) method. Consequently, out-of-sample method forecasts for five subgroups of countries, thus providing different benchmarks for China, are compared with official data. The conclusion argues the NPLs ratio to be understated in official statistics, especially towards the end of the series, which might be a sign of increasing macroeconomic instability in China.