This thesis discusses the issue of nonperforming loans in China, and the financial sector developments 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 the key contributing factors of the NPLs. Utilizing a sample of 23 countries over the period 2000-2009, we estimate the impact of macroeconomic determinants on NPLs. 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, which thus provide 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. Finally, the independence of the China's central bank to report the true NPLs ratio is inferred from a monetary policy study which utilizes the Havrilesky method.